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REGULATION OF LIFE INSURANCE IN TEXAS: A STUDY

OF THE IMPACT OF REGULATORY POLICIES ON

INDUSTRY STRUCTURE, BEHAVIOR

AND PERFORMANCE

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The idea for study of Texas life insurance companies came from a series of articles by Thomas H. Thompson, then Editor of the Amarillo Globe-Times. For more than a year before I began this study I counseled with him about the subject. His advice, along with the files he turned over to me at the time he left the paper, have proved of great help.

In the process of gathering and analyzing data, many persons have been extremely helpful. It would be impossible to acknowledge my debt to all, but four stand out in a special way: Joe Christie, Chairman, Texas State Board of Insurance; Don J. Willmon, Chairman of the Board and Chief Executive Officer, United Bankers Life, Dallas; E. Jay O'Keefe, President. Western National Life, Amarillo; and Dr. Zeke Marchant, C.L.U., Head, Department of Business Administration, West Texas State University. Each of these has rendered unique and valuable assistance which is greatly appreciated.

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CHAPTER I

INTRODUCTION

Purpose of the Study and Importance of the Industry

Purpose of the Study

The purpose of this study is to analyze the effect of administrative regulation on the life insurance industry in Texas. Although the industry is a very significant part of the private sector of our economy--particularly in Texas--it has been largely ignored in economic analysis. As a result of several unique characteristics, the industry is subject to comprehensive regulation, yet this regulation differs considerably from that found in other industries. The products of the industry are almost ubiquitious[1] yet even their costs

[1]At the end of 1972, some 140 million persons, or one out of every three people in the country, were insured by some form of policy issued by a legal reserve company. Life Insurance Fact Book, 1973, (New York: Institute of Life Insurance, 1973), p. 9. A survey made in 1969 revealed that eighty per cent of the total adult population had some form of life insurance. Ibid., p. 14.

are not clearly understood by a large proportion of those who buy them.

The study will examine the structure, behavior, and performance of the industry, and, when possible, will use microeconomic theory as a tool of analysis. But because of the nature of the industry, conventional analytical methods will not always be practicable. Empirical study will be used to help explain the industry and the impact of its regulation.

Based on the analysis made, the thesis will determine whether or not regulation in Texas has significantly changed the organization of the individual life insurance firm, as well as the structure of the entire industry. Since it is almost certain that regulation will continue, recommendations will be made for changes in regulatory policies. Throughout the study cognizance will be taken of the "political" factors, i.e., the influence of interested parties, which cannot be overlooked if one is to understand the operation of the industry.

Importance of the Industry

Every year 140 million consumers in the United States spend about $25 billion for various types of life insurance.[1] When all other sources of income of the life insurance companies are included, the total is close to $60 billion.[2] In addition

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[1]United States, Congress, Senate, Committee on the Judiciary, The Life Insurance Industry, Hearings Before the Subcommittee on Antitrust and Monopoly. Ninety-third Congress, First Session, 1973, p. 1.

[2]Life Insurance Fact Book 1973, p. 7.

to the number of people involved as policyholders, the life insurance industry is important in other ways. At the end of 1972 the life insurance in force in the United States was $1,627,985,000,000.[1] According to one of the standard texts in the insurance field, "Individual insurance represents the oldest economic security system."[2]

Life insurance companies are also a significant source of loanable funds, supplying seven per cent of the total funds flowing into financial markets.[3] In January of 1974 the total assets of the industry were $253,531,000,000. Approximately half of these assets consisted of business securities--stocks and bonds--and almost a third were real estate mortgages.[4] This investment position contrasts with the idea held by some--and certainly true at an earlier time--that insurance companies were ultraconservative in their investment practices. One recent study of financial institutions summarizes the situation, "Life insurance companies are dynamic investors who assume reasonable investment risk, and thereby contribute to the growth of the American economy."[5]

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[1] Ibid.

[2] S. S. Huebner and Kenneth Black, Jr., Life Insurance, 7th ed., (New York: Appleton-Century-Crofts, 1969), p. xxxiv.

[3] Life Insurance Fact Book, 1973, p. 69. The only sources which supplied greater amounts were: commercial banks, 34 per cent; savings and loan associations, 18 per cent; and state and local funds, 8 per cent.

[4] Federal Reserve Bulletin 60 (May, 1974): Table A3.

[5] Murray E. Polakoff, et al., Financial Institutions and Markets (Boston: Houghton Mifflin Co., 1970), p. 158.

The life insurance industry is singularly important in the State of Texas. The Chairman of the State Board of Insurance, Joe Christie, speaking before the Amarillo Rotary Club on February 7, 1974, characterized it as the largest industry in the State. At the end of 1972, the life insurance in force in the State was $87,069,000,000, with $9,460,000,000 having been sold in Texas that year.[1] Former Governor Price Daniel expressed his belief in the importance of insurance to the individual in a special message to the Fifty-fifth Legislature on February 12, 1957, "It involves the financial security of most of our people, rich and poor alike. Insurance is the primary safeguard which our people have against possible future loss and disaster."[2]

Neglect of the Industry in Economic Analysis

Despite this seeming importance, economists have paid little attention to the industry. There is a great volume of literature dealing with the "selling" of life insurance and with reasons for its purchase. This is obviously aimed at life insurance agents, but much of it is consumer oriented. In beginning this study the author wrote several well-known economists to seek their help in locating pertinent analytical material about the industry. Among the replies were the following: From Professor George J. Stigler of the University of

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[1] Life Insurance Fact Book, 1973, pp. 7 and 23.

[2] Quoted in Amarillo Globe-Times, April 17, 1972.

Chicago, "I haven't done any work nor indeed followed the work of others in the area of life insurance . . . ."[1] From the Chairman of the Department of Economics of Columbia University, Professor Donald Dewey, "I regret that I cannot be of a significant help to you on your doctoral research. There has been an astounding neglect of the insurance industry by economists in recent years as you have painfully discovered."[2]

One well-known text in the field of industrial organization mentions the industry, only to dismiss it from consideration, "We shall have very little to say about . . . the banking, finance and insurance industries, which belong conventionally to the fields of money and banking."[3]

A recent study by Professor Paul L. Joskow of M.I.T. makes this comment about such an attitude:

> Scherer's relegation of the industry to the "money and banking" field may be justified in the context of past research work available, but it seems unfortunate that such an important private sector of the U. S. economy has not undergone more intensive study and analysis in the context of the structure-behavior-performance rubrick of industrial organization.[4]

Although Professor Joskow's analysis is directed primarily to the property-liability sector of the industry,

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[1]George J. Stigler, letter to the writer, dated October 12, 1973.

[2]Donald Dewey, letter to the writer, dated October 22, 1973.

[3]F. F. Scherer, Industrial Market Structure and Economic Performance (Chicago: Rand McNally and Co., 1971), p. 2.

[4]Paul L. Joskow, "Cartels, Competition and Regulation in the Property-liability Insurance Industry." The Bell Journal of Economics and Management Science 5 (Autumn '73): 375-6.

the letters quoted above would indicate there has been a similar scarcity of study in the life insurance field. In 1969 there was published a rather comprehensive study of industrial regulation entitled, The Regulators-Watchdog Agencies in the Public Interest.[1] The book has no chapter on insurance, and the two references in the index are quite insignificant.

Spokesmen for the business community also seem to ignore or overlook the life insurance industry when the pervasiveness of government regulation is being expounded. The Chairman of the Board of Directors of the First National City Corporation, writing in the conservative National Review, failed to mention insurance, though his list was not all-inclusive:

> The American bureaucracy regulates the utilities which produce heat, light and power; the railroads (or what's left of them); trucking companies, airlines, broadcasters, drug firms, dry cleaners, automobile manufacturers, meat packers, film makers, farmers, brokers, banks, and a host of other enterprises. Most of these industries are highly competitive, but government has decreed that they serve a variety of objectives other than selling their products at the lowest possible price.[2]

There is a similar lack of attention to the industry in current economic literature. A rather concentrated search

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[1] Lewis M. Kohlmeier, The Regulators--Watchdog Agencies in the Public Interest (New York: Harper and Row, 1969). While this study deals primarily with federal regulations, it includes areas of concern to the State, such as intra-State telephone rates.

[2] Walter B. Wriston, "Whale Oil, Baby Chicks, and Energy," National Review, June 7, 1974, p. 645.

of economic and political science journals for the last few years was made in two general areas: industrial organization and governmental regulation; and in publications specifically in the insurance field. Except for the last category, very little was found that was applicable.

In the field of governmental regulation, most of the articles dealt with transportation or utility rates, although one relatively new field--the regulation of cable television--received some attention.[1] There were several articles dealing with barriers to entry, both as a regulatory device and as evidence of market imperfection. More specific reference to these will be made in the section of Chapter II dealing with Behavior in the Industry. In publications such as the Public Utilities Fortnightly were several articles dealing with the theory of differential rates. Primarily their purpose was to use orthodox price theory as a defense against the idea of an "inverted" utility rate structure to cut down usage for environmental reasons. As will be shown in the next chapter, there is differential pricing in life insurance, but rates are not specifically regulated.

In such trade publications as The Journal of Risk and Insurance there were, of course, articles dealing with the industry. Several of these addressed the question of solvency,

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[1]The American Economic Association includes papers on about twenty topics at each annual meeting. In only one of the last several years has more than one of these dealt with industrial organization or public regulation. None dealt with the life insurance industry.

and one dealt at length with concentration in the industry.

In both economic and political science journals there were articles dealing with antitrust actions. Since insurance, as a regulated industry, is largely exempt from antitrust, these were not applicable to the study at hand.

Current Interest in the Industry

Despite the lack of analysis by economists, the insurance industry has received increasing attention from other sources in recent years. In the movement which has come to be known as "consumerism" there is a great deal of interest in the industry. Herbert S. Denenberg, a former Professor of Insurance at the University of Pennnsylvania, served for several years as Commissioner of Insurance in the State, and was a vigorous exponent of what he considered to be the consumers' interests.[1] He published in 1972 and 1973 _A Shopper's Guide to Life Insurance_, _A Shopper's Guide to Term Life Insurance_, and _A Shopper's Guide to Straight Life Insurance_.[2] This latter includes, for instance, the following charts: 1) Ranking of $10,000 and $25,000 participating policies of the 35 largest companies, 2) Ranking of 10 Highest and Lowest cost $10,000 participating policies of all companies

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[1]Commissioner Deneberg resigned to seek the Democratic nomination for United States Senator in the spring of 1974, but was defeated in the Primary election.

[2]Harrisburg, Pa.: Pennsylvania Insurance Department. The Department also published Guides to hospitals, surgery, dentistry and mobile home insurance.

in Pennsylvania, 3) Ranking of $10,000 and $25,000 non-participating policies of the 20 largest companies, 4) Ranking of Lowest and Highest Cost $10,000 non-participating policies of all companies in Pennsylvania.

In the foreword to the Second Edition of the Shopper's Guide to Straight Life Insurance (June, 1972) Commissioner Denenberg reported:

> These Guides have become part of one of the most successful consumer education programs ever launched. The Insurance Department has printed and distributed over 600,000 of these Guides, and several million of our Guides are in circulation. We have granted permission to reproduce these Guides to various consumer organizations, unions, government agencies, large employers, Blue Cross and insurance companies, and many others.

Reaction to the Guides has been varied.[1] Best's Weekly News Digest, Life/Health Insurance Edition of June 12, 1972, reported:

> Seven weeks after publication, the Pennsylvania Shopper's Guide to life insurance has not had much impact on the sales in that State of companies included on the Guide lists of the ten highest and lowest cost companies, nor has it caused any wide-spread alarm among agency department heads at companies in the high-cost category.

Subsequent to that time the Pennsylvania Insurance Department has been involved in some litigation concerning the accuracy of some of the figures used.[2] There seems to

[1]Insurance Commissioner Joe Hunt of Oklahoma has said they were "worthless." (Southwest Insurance Regional, July 31, 1973, p. 1).

[2]According to The National Underwriter, Life and Health Insurance Edition, February 9, 1974, "A commonwealth court judge has ordered Commissioner Herbert S. Denenberg of Pennsylvania to stop releasing information from a draft of his Shopper's Guide to the 100 Insurance Companies That Consumers Complain About Most." (p. 1.)

be rather general agreement in the industry, however, that this sort of activity will continue, and that all companies must be prepared to provide accurate and adequate cost information.

The activities of Commissioner Denenberg have stimulated similar ventures on a commercial basis. A New York publisher of paper backs, Davis Publications, Inc., put out A Davis Compact Guide, How To Save Money on Life Insurance (1972 Edition). On the title page is the statement, "Grateful acknowledgement is made to the Insurance Commission, State of Pennsylvania, and to the Press and Editorial Division, Institute of Life Insurance, for certain material that appears in this book."[1]

The year 1972 also saw the issuance of a Revised Edition of the Consumers Union Report on Life Insurance.[2] In the Introduction it is reported that the November, 1937, issue of Consumer Reports (one year after the organization's founding) began a ten-installment discussion of life insurance. In 1967 a four-part series reported again on the industry, and this was expanded into the 1972 book.[3] Consumers Union reported, however, that the expanded study proved somewhat of a failure as "a large representation of insurance companies,

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[1] How to Save Money on Life Insurance, A Davis Compact Guide, (New York: Davis Publications, 1972).

[2] The Consumers Union Report on Life Insurance. Revised Edition (Mount Vernon, New York: Consumers Union of the United States, Inc., 1972).

[3] Ibid., p. 7-8.

including all the biggest ones (were unwilling) to cooperate by supplying needed data."[1] Although their Guide supplies much helpful information, they conclude, "Like so many major buying decisions, the purchase of life insurance is much more difficult than it ought to be."[2]

In an effort to make the buying of insurance easier for the consumer--and to meet some of the concerns which have brought forth the Pennsylvania Shopper's Guides--several states have issued orders that new types of cost information must be supplied at the time of purchase of life insurance. The actual premium paid is a very inexact measure of the cost of life insurance, and there are a number of methods which attempt to express the cost more exactly. The so-called "interest-adjusted" method (which will be explained in Chapter II) has more support than others, but it is by no means universally regarded as a measure of the true cost of insurance.

In October, 1973, the Insurance Department of Arkansas issued an order (to take effect February 1, 1974) that the "Life Insurance Interest Adjusted Cost Comparison Index" must be used.[3] A similar order was issued in Texas to take effect April 1, 1974,[4] however, representatives of the industry have

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[1] Ibid.

[2] Ibid., p. 11.

[3] Arkansas Insurance Department, Rule and Regulation 17, October 19, 1973.

[4] Texas State Board of Insurance Order No. 26809.

urged that its implementation be suspended for further study, and the Texas order is now scheduled to take effect September 15, 1974.[1]

These efforts are intended to help the consumer arrive at the true cost of his insurance, but, as will be brought out more clearly in the next chapter, cost is not the only consideration in buying insurance. A spokesman for the industry wrote this in 1972:

> Even the most dedicated consumerist--and we have talked to more than a few of them--will admit that less than 5 per cent of the permanent life insurance policies sold in the United States and Canada are purchased on the basis of cost. The figure is probably closer to 2 per cent to 3 per cent.
>
> Joseph M. Belth, professor of insurance at Indiana University, and the man who must be given a large part of the credit for the donnybrook in which the industry finds itself, repeatedly points out in his book, The Retail Price Structure in American Life Insurance, that he does not intend to suggest that price is the only factor that should be considered in the purchase of life insurance.[2]

A major inquiry into the operations of the life insurance industry was conducted by Senator Philip A Hart of Michigan. As Chairman of the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, he conducted hearings in February, 1973, which, together with Material Received for the Record, covered 2216 pages in a three-part report.

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[1]Texas State Board of Insurance Order No. 27022.

[2]William McFarlane, "Consumerism: No Longer a Non-Word," The National Underwriter, Seventy-fifth Anniversary Edition, 1972, p. 36.

In his opening statement Senator Hart set out several concerns which he and others had about the life insurance industry, and which he hoped the Hearings would help to resolve. These included the lack of knowledge on the part of consumers as to what part of their premiums went into savings and what part into death protection, an antitrust concern over the way the life insurance market operates, proliferation of types of policies, the fact that . . . the average family gets little money when the breadwinner dies," and "restrictions on the competition which comes from State laws and regulations, and perhaps from industry activities."[1]

Senator Hart announced on March 5, 1974, that he was drafting a "Truth in Life Insurance" bill. He said that hearings by the Senate Antitrust and Monopoly Subcommittee and information gathered since from more than 200 companies convinced him consumers are not getting "clear, accurate, reliable and adequate information about the cost and value of the policies they buy." An additional feature of the bill would provide "some protection for agents" in allowing them to sell for more than one company. A requirement that "the summary measure of price show a breakdown between the protection element of the policy and the savings element" is

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[1] The Life Insurance Industry, Hearings before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, United States Senate, Ninety-third Congress, First Session, Part 1, February 20, 1973, p. 1.

sure to be one of the most controversial provisions of the bill.[1] Industry spokesmen oppose this strongly, saying it would violate the concept of level premium life insurance.[2]

As would be expected, much of the concern about life insurance covers the possibility of company insolvency. A few states, including California, Illinois and Texas, have been working for several years on the possibility of "early warning" tests which would give an indication of pending trouble well before any crisis becomes apparent. The process of full examination of a company may take many months. If the company is in trouble, much damage can take place during that time. As with the rumor of a failing bank, the actions based on the rumor may well create a condition which had not theretofore existed.

The National Association of Insurance Commissioners in 1973 contracted with the management consultant firm of McKinsey and Company at a cost of $500,000 to conduct a study of insurance regulators, and to try to devise a financial condition surveillance system to reveal early clues to potential insurance company insolvencies.[3] The Wall Street

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[1]Press Release, Office of Senate Antitrust and Monopoly Subcommittee, March 5, 1974 (mimeographed). Information received from Senator Hart's office in late June, 1974, indicated the bill had not yet been introduced.

[2]Appendix "F" contains a statement explaining this concept.

[3]Suzanne T. Turner, Press and Community Relations Specialist, The Mutual Life Insurance Co of New York, letter dated March 14, 1974.

Journal of May 24, 1974, states that the McKinsey report is very critical of present regulatory practices, and singles out dishonesty as the primary cause of insolvency. The newspaper further reports that a representative of the NAIC challenges this finding, saying, "The McKinsey statistics are different from what our observations have been. I think dishonesty in the insurance business is minimal. There are about 1800 United States life insurance companies in operation today, and I think you could logically expect that some of them aren't going to make it."[1]

Methodology

The items cited in the previous section show the concern which various groups have about the life insurance industry. Each is valid in its own way, but none approaches the problem from the viewpoint of this study, which will attempt to look at the institutional realities of the life insurance industry in the light of microeconomic theory. The study will be empirical, with no construction of a model and testing of hypotheses.

An industry embracing a segment of the economy of the magnitude of the life insurance industry certainly merits investigation. Its importance as a means of saving as well as a source of funds are significant in our economy. The

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[1]"Dishonesty is Said to Cause Insolvency Among Life Insurers," The Wall Street Journal, May 24, 1974, p. 3. The part of the McKinsey Report dealing with Early-Warning tests will be discussed in Chapter V.

regulatory practices obviously have much impact on the nature of the industry. Certain aspects of life insurance operations will need to be considered on an industry-wide basis, as economic theory recognizes no state boundaries. However, insurance is one of the few regulated sectors of the economy which comes under state rather than federal control, so the state is a logical unit (market segment) for study. The impact of regulation in Texas will be of prime concern.

Former Insurance Commissioner Denenberg and two members of the faculty at the University of Pennsylvania have made a study of concentration in the life insurance industry, in which they indicate the relevancy of the State as the proper market segment for study. They point out the such a study must concern itself with relatively homegeneous market segments:

> (Such a study) seems particularly vulnerable in the problems associated with aggregation because of the inherent heterogeneity of the insurance products in the market place. . . . However, there is a considerable justification for choosing the state as a relevant market segment for the measure of concentration. Three major reasons may be noted: (1) the insurance industry is a state regulated industry; (2) the marketing of life insurance is essentially a regional endeavor; and (3) buyers of insurance can be more readily classed into relatively homogeneous groups on a state basis than on a national basis.[1]

They further point out that since the influence of the State is so pervasive in the sale of insurance, "It thus

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[1]J. David Cummins, Herbert S. Denenberg and William C. Scheel, "Concentration in the U. S. Life Insurance Industry," Journal of Risk and Insurance 39 (June, 1972): 177.

has a vested interest in assuring the successful operations of insurance companies within its borders.[1]

In many ways operations of Texas companies are quite similar to those of companies in other states, but where there are differences because of Texas regulations, an attempt will be made to explain them. There is ample support for the process of using theory as a guide to regulation, even though it has been largely ignored in the life insurance field. Professor Alfred E. Kahn of Cornell University follows this approach.

> Microeconomic theory provides regulators with a set of principles that, if followed, will produce optimum results, by widely accepted criteria of optimality. The principles are at one and the same time behavioral rules describing how prices should be set, investment decisions guided and so forth, and descriptions of the ideal results that those rules are supposed to produce--notably the use of society's limited resources in such a way as to maximize consumer satisfactions.[2]

Professor George W. Stocking cautions against following theory which has become outmoded:

> To classical and neoclassical economists markets fell into two relatively simple categories, competitive and monopolistic, and they developed a lucid and logical explanation as to how price was determined in each and how it functioned in the allocation of resources and the distribution of income. As their theories gained in refinement and precision, they lost in reality. Edward Chamberlin was the first in this

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[1] Ibid., p. 179.

[2] Alfred E. Kahn, The Economics of Regulation: Principles and Institutions, 2 Vols., (New York: John Wiley and Sons, Inc., 1970), Vol. I: Economic Principles, p. 17.

> country to give systematic expression to a logic better adapted to the market structure of contemporary industrial society.[1]

This study will attempt to deal both with the institutional realities and the theoretical concepts in the manner described by Professor Kahn:

> What institutional incentives, compulsions and arrangements will play the same role where the "invisible hand" of competition is for one reason or another infeasible? "The visible hand of regulation" is not a sufficient answer . . . . In view of the historic controversies in economics between "theorists" or, more precisely "classical economists" on the one hand, and "institutionalists" on the other, it is important to emphasize that we intend to imply no such dichotomy . . . . On the contrary, the micro theory that is divorced from institutional realities is sterile. The essential task of useful theory is precisely to identify the important institutional determinants of economic behavior--such as number of sellers, barriers to entry, complexity of product, shape and character of the production cost function, or the presence of regulation--and to formulate hypotheses about their impacts on the various aspects of performance. Conversely, the "institutional economics" that is informed by no theory . . . is no science at all.[2]

Sources of Information

The original inspiration for this study came from a series of articles in the Amarillo Globe-Times in the spring of 1972, by its Nobel Prize-winning Editor, Thomas H. Thompson. These articles were quite critical of insurance regulation in Texas. Mr. Thompson subsequently left the newspaper to enter the academic world, and turned his files over to the

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[1] George W. Stocking, Workable Competition and Anti-trust Policy, (Nashville: Vanderbilt University Press, 1961), p. v.

[2] Alfred E. Kahn, op. cit., pp. 18-19.

writer of this study. At that time the writer and Mr. Thompson counselled with Jose Rael, an Amarillo agent of the Equitable Life Assurance Society. Mr. Rael has earned the Chartered Life Underwriter diploma, and has studied the insurance field extensively. He has been very helpful throughout the investigation. Furthermore, as a stockholder in both successful and unsuccessful insurance companies who has attended annual meetings and studied their annual reports, the writer has some personal knowledge on which to build.

At West Texas State University in the spring of 1973 the writer taught the Economics Section of the course designed for the Chartered Life Underwriter degree of the American College of Life Underwriters. The members of the class were Branch Managers and leading agents who aspired to the professional designation of Chartered Life Underwriter. The subject material was from a standard economics text,[1] supplemented by material from the American College of Life Underwriters especially pertinent to the industry. This course provided the writer with a unique opportunity for acquiring knowledge about the industry and its operating problems.

Early in the summer of 1973 the writer spent about ten days in Austin, Texas, interviewing and using library resources. Some of the interviews were arranged through

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[1]Paul A. Samuelson, Economics, 8th Ed. (New York: McGraw-Hill, 1970).

friends in Amarillo who were well acquainted in Austin; Lawrence Hagy, independent oil operator, former mayor, and former President of the Texas Research League;[1] Wales Madden, attorney and former Regent of the University of Texas; and Representative Ben Bynum, Chairman of the Insurance Committee of the House of Representatives. Representative Bynum was extremely helpful in explaining the insurance problems which had come before the Legislature in the then just-concluded Sixty-third Session.

Interviews in Austin began with Joe Christie, Chairman, State Board of Insurance; Durwood Manford, Member of the Board; and Clay Cotten, Insurance Commissioner. Next was Stuart Long, Publisher of the Austin Insurance Report, issued weekly with information of interest to all phases of the industry. (There is also a Legislative Edition, published while the Legislature is in session to provide current information in greater depth than the regular report.) The files of these publications for the last several years were examined and studied. Mr. Long has been a Capitol Correspondent for almost thirty years, and has an extensive knowledge of all phases of state governmental activity.

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[1]A privately financed organization for studies of governmental operations. It made a comprehensive study of the State Board of Insurance in 1958, Regulation of Insurance in Texas; The Job Being Done, The Needs to be Met (Austin: Texas Research League, 1958). The writer also had access to supporting Memoranda Nos. 1-19, (mimeographed) from the files of the Texas Research League.

Forrest C. Roan, Chief Clerk of the Insurance Committee of the House of Representatives, was very helpful in supplying copies of insurance bills passed in the recent legislature and in explaining why some had passed and some had not. Sam J. Winters, Attorney for the Texas Life Convention, explained the part his organization had taken in the Guaranty Bill, just passed, as well as the overall interests of the organization he represented (some of the larger companies in the State.) Professor Robert C. Witt of the University of Texas, a graduate of the University of Pennsylvania with doctoral research in insurance, provided copies of some of his own publications, as well as guidance in literature that was available.

In October, 1973, a second visit was made to Austin to inquire more specifically about certain aspects of Board operations. Don Dunham, Deputy Assistant Administrator, supplied this information. A very brief conversation was held with Ned Price, the third member of the State Board. On this visit, Dave Smith, Executive Secretary of the Texas Legal Reserve Officials, was interviewed. This is an organization of representatives of medium-sized life insurance companies. The interview with Mr. Smith was arranged by Don J. Willmon, Chairman of the Board and Chief Executive Officer of the United Bankers Life Insurance Company.

The writer was formerly a stockholder and policyholder of that company, and has talked with Mr. Willmon about insurance problems on numerous occasions--more specifically in the last two years as a part of this study. Mr. Willmon, on his own initiative, sought information for the writer from officials of several other companies.

In August, 1973, the writer interviewed Joe Hunt, Oklahoma Insurance Commissioner, Gerald Grimes, Deputy Commissioner and Eva Pogue, Chief Actuary. All were extremely helpful in providing information.[1]

There are two others who have been continuing sources of information and guidance. Dr. Zeke Marchant, Professor of Insurance and Head, Department of Business Administration, West Texas State University, has been a great help in many ways. He has experience in both the business and academic worlds, and provided a number of books and periodicals which were not otherwise available. E. Jay O'Keefe, President of Western National Life Insurance Company of Amarillo, was formerly the company's actuary. He has been most helpful in explaining the concept of the "interest-adjusted cost index," and many other aspects of the industry.

During the summer visit to Austin, the reports of the Texas Research League which pertained to the State Board of Insurance were studied, as were reports in the Texas Legislative Library. The University of Texas Library was used

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[1]Commissioner Hunt issued the writer a Commission as an "Honorary Deputy Insurance Commissioner of Oklahoma."

extensively, including a number of doctoral dissertations and some master's theses.

The University of Oklahoma and West Texas State University libraries were also used in these studies. The facilities of Interlibrary loan were used on several occasions to secure books and periodicals from the University of Indiana and Southern Methodist University. Copies of five dissertations were purchased from University Microfilms, and micofilm copies of twelve were ordered for the writer by the University of Oklahoma Library (through the courtesy of the Chairman of his Committee).[1]

The libraries were used extensively for books, periodicals and government documents. Textbooks for courses in price theory, industrial organization, government regulation and insurance were used, along with professional journals in all these fields. Trade journals for insurance agents and executives are prolific, and many were examined. There are

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[1]The University of Pennsylvania has been the source of the greatest amount of doctoral research in the insurance field. Obviously this is influenced by the presence there of the S. S. Huebner Foundation for Insurance Education. The University of Indiana has also engendered a good bit of research in this field. Professor Joseph M. Belth, Professor of Insurance at that University, has written extensively about insurance, and will be quoted a number of times in this paper. The Universities of Texas and Wisconsin have each had several dissertations dealing with insurance in recent years. Most of the balance have come from the other large Midwestern State universities.

In the main, these have dealt with specific operating problems, or with hypothetical models of operations under various assumptions. None has dealt in an overall way, however, with the use of economic theory as a guide to understanding the operations of the life insurance industry.

many insurance company histories, together with histories of the industry both in the United States and England. Several of these are "Centennial Histories," and they provided much information about both operations and regulations. Studies of regulation in other industries were examined for possible application to the insurance industry. Government documents of various kinds were also used; such as reports of the Temporary National Economic Committee, Congressional hearings and reports, and reports of various state agencies.[1]

There is quite a variety of information published for the industry, and various types of reporting and rating services about companies and policies. Some of the better-known publications are: National Underwriter; Life, Insurance Advocate, Weekly Underwriter, Best's Review; Life/Health, Insurance Magazine, CLU Journal, Life Association News and Journal of Risk and Insurance.

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[1]There are several books which are extremely critical of the entire life insurance industry. While they should not be overlooked, they have contributed little to an understanding of the industry. Among those examined by the writer were: Edward Berman, Life Insurance; A Critical Examination (New York: Harper and Bros., 1936); Mort Gilbert, Life Insurance; A Legalized Racket (Philadelphia: Marlowe Publishing Co., 1936); Ralph Hendershot, The Grim Truth About Life Insurance (New York: G. P. Putnam's Sons, 1957); Jay Douglas Kidder, Life Insurance, America's Greatest Confidence Game (Seattle: George E. Minor Press, 1938). Generally the life insurance industry has ignored such attacks, but the Institute of Life Insurance prepared a rebuttal to the Hendershot book. It was a nine page mimeographed booklet, "Memorandum Concerning Background Facts Pertaining to the Book, The Grim Truth About Life Insurance by Ralph Hendershot, published by G. P. Putnam's Sons," This was published in 1957.

Chapter Outline

The remainder of this study will be organized as follows: Chapter II, The Nature of the Life Insurance Industry. Beginning with a definition of insurance, and a brief early history of the industry, the chapter will explain the structure, behavior and performance of the life insurance industry. It will show how economic theory can be helpful in understanding these various aspects of the industry. Chapter III, History of Industry Regulation, will consider the characteristics which have created a demand for regulation and will outline the legal basis for regulation. It will examine two major investigations of the industry: the Armstrong Investigation in New York in 1905, and the study conducted by the Temporary National Economic Committee in 1939 and 1940. Chapter IV, The Life Insurance Industry in Texas, will describe the industry in Texas, particularly as its companies and policies differ in part from those in other states. Chapter V, Regulation in Texas, will tell of the influence on the industry of the Robertson Act of 1907, and will describe the current procedures of the State Board of Insurance, including the types of disciplinary action available to the Board. The Chapter will also describe the latest types of "early-warning" tests which have been devised in a study sponsored by the National Association of Insurance Commissioners. Chapter VI, Conflicting Purposes of Regulation, will list some of the various goals of regulation and show how they can conflict in theory and practice. The ways in which the Texas regulatory system places strong emphasis on certain goals which are but lightly regarded in other states will be explained. In Chapter VII the writer's conclusions from the study will be summarized, and recommendations will be made for modifications in state regulations and company operations.

CHAPTER II

THE NATURE OF THE LIFE INSURANCE INDUSTRY

The previous chapter has indicated something of the importance of life insurance, and the neglect it has faced at the hands of economists. This chapter will first define insurance and briefly recount its early history. The major portion of the chapter will seek to analyze the industry on the basis of its structure, behavior and performance. A good definition of these terms has been given in an article addressed to attorneys seeking help in determining whether or not an industry is competitive.

> The term "structure" refers to, at a minimum, the industry's (1) concentration ratio, (2) the degree of product differentiation present in it, and (3) the height of any additional entry barriers around it. "Conduct" refers principally to the behavior pattern employed by the industry's firms in arriving at their price, product and output decisions, particularly whether they make those decisions independently, collusively, or interdependently. The term "performance" refers to the ultimate economic _results_ produced by those structural features and conduct patterns, that is, to its (a) efficiency, (b) price stability, and (c) technological progressiveness, and (d) contribution to the general goal of equity in the distribution of income.[1]

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[1]Charles E. Mueller, "Lawyer's Guide to the Economic Literature on Competition and Monopoly: An Introduction to the Doctoral Dissertations (II)," _Antitrust Law and Economics Review_ 6 (Fall, 1972): 72.

This chapter will seek to cover these points, and others, particularly in the structural area. A more complete description of companies and types of products will aid in understanding the industry.

Definition of Insurance and Early History

In a very broad sense the key characteristic of insurance is the substitution of certainty for uncertainty. Life Insurance is concerned with the uncertainty of premature death, and with financial loss which might be suffered as a consequence. One leading textbook describes it this way:

> From the community standpoint life or health insurance may be defined as that social device for making accumulations to meet uncertain losses resulting from premature death or disability which is carried out by the transfer of risks of many individuals to one person or a group of persons.[1]

The text further defines life insurance from an individual standpoint as:

> Consisting of a contract, whereby for a stipulated consideration, called the premium, one party (the insurer) agrees to pay the other (the insured), or his beneficiary, a fixed sum upon the occurrence of death, disability, or some other specified event.[2]

The Texas Insurance Code of 1969, As Amended, defines a life insurance company as follows:

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[1]S. S. Huebner and Kenneth Black, Jr., Life Insurance, 7th ed., (New York: Appleton-Century-Crofts, 1969), p. 3.

[2]Ibid.

> A life insurance company shall be deemed to be a corporation doing business under any charter involving the payment of money or other thing of value, conditioned on the continuance or cessation of human life, or involving an insurance, guaranty, contract or pledge for the payment of endowments or annuities.[1]

This seems a very straight-forward definition, with little posibility of misunderstanding, yet a different point of view may call for a different idea. As expressed by Irving Pfeffer in Insurance and Economic Theory, "the economist, the historian, the legislator, and the businessman each has a different idea as to the nature or scope of the term."[2]

An even more forward-looking analysis is presented in a 1969 study published for the S. S. Huebner Foundation for Insurance Education:

> What will be considered "insurance," and thus be legitimate within this part of the economy? Only such activities as are "insurance" will be subject to insurance regulation. Variable annuities fall in the shadowy borderland between insurance and securities. What new forms of "securities" will have to be fitted into a dual regulatory scheme as both insurance and securities? Or will the one regulatory scheme squeeze out the other? What warranties, expanded beyond current concepts, will be subjected to control as "insurance"? How will new and old forms of insurance stricto sensu be encouraged, circumscribed or forbidden by the application of the regulatory machinery? What kinds of insurance, yet to be created, will be sanctioned or prohibited?[3]

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[1] Texas Insurance Code 1969 (Austin: State Board of Insurance, 1969), Sec. 1, p. 49.

[2] Irving Pfeffer, Insurance and Economic Theory (Homewood, Ill.: Richard D. Irwin, Inc., 1956), p. 9.

[3] Spencer L. Kimball and Herbert S. Denenberg, eds., Insurance, Government and Public Policy, Studies in Insurance Regulation (Homewood, Ill.: Richard D. Irwin, Inc., 1969), p. 486.

The current study will not attempt to answer all the above questions, but they are enumerated to indicate the overall scope of the insurance field. For the purposes of this study, the definition given in the Texas Insurance Code will be followed.

Early History of the Industry

The concept of life insurance has existed for many centuries. As an organized business, however, it is generally traced to England in the 17th century. The first life insurance company in America was founded in 1759 by the Presbyterian Synods of New York and Philadelphia. It was known as the Corporation for the Relief of Poor and Distressed Presbyterian Ministers and for the Poor and Distressed Widows and Children of Presbyterian Ministers. It is now known as the Presbyterian Ministers Fund, and ranks among the fifty largest mutual companies from the standpoint of assets.[1] By 1804 there were forty insurance companies of all types, with a total capital of $10,000,000.[2]

In Texas the first two insurance companies were organized in 1840, and chartered by the Congress of the Republic

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[1] Best's Insurance Reports, Life/Health, 1973, p. 1340. At the end of 1972 its assets were $139,366,561 and insurance in force was $642,897,638.

[2] Samuel Blodget, Economica: A Statistical Manual for the United States of America (Washington, 1806). Quoted in Douglass C. North, The Economic Growth of the United States 1790-1860 (New York: W. W. Norton & Co., 1966), p. 54.

of Texas. Under statehood the first companies were chartered by a special Act of the Second Legislature in 1848. The Fifth Legislature in 1854 chartered the Red River and Texas Insurance Company--a combined fire, marine casualty and life insurance company--with a capital stock of $75,000.[1] By 1874 there were twelve life insurance companies licensed in the State.[2]

Organization

Despite its long history, the operations of the insurance industry are understood by very few persons. Following the analysis outlined above, the first area of study will be the structure, or organization, through which these operations are conducted. The questions which this paper will seek to answer are well outlined by George W. Stocking.

> By an industry's structure economists refer to an industry's makeup, how it is put together, how its parts are interrelated. How many firms are in it? What is their relative size? Does a single firm dominate it? How difficult is the movement of resources into and out of it? What are the limits of its market? How sharply is it differentiated from other "industries" producing rival products readily substitutable for the products it makes? Economists believe that the answers to such questions will throw some light on the effectiveness or workability of competition.[3]

Micro Aspect

With a few minor exceptions the life insurance business

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[1]George L. Curry, General Insurance for Texas (Houston: Southwest Educational Publications), p. 1.

[2]Ibid.

[3]George W. Stocking, Workable Competition and Antitrust Policy (Nashville: Vanderbilt University Press, 1961), p. 122.

in the United States today is carried on through corporations.[1] These are of two basic types: the stock insurance company and the mutual insurance company.[2] The stock company is owned and controlled by the stockholders, whose interest is in making a profit through providing service to the policyholders. Any excess of income above needs for losses, expenses, reserves and surplus may be paid in dividends to the stockholders. Some stock companies provide for a return of some of their gain to their policyholders, and are known as participating stock companies.

A mutual insurance company is owned, and, in theory, controlled by its policyholders. Any excess gain above losses, expenses, reserves and surplus <u>must</u> be returned pro rata to the policyholders. In some cases policyholders of mutual companies may be called upon to share in the company's losses if its assets are not adequate.[3]

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[1]The <u>Texas Insurance Code 1969</u>, As Amended, makes provision for unicorporated Fraternal Benefit Societies (Chapter 10), Local Mutual Aid Associations (Chapter 12), Burial Associations (whose benefits may be paid partly in merchandise and services--Chapter 12), and Statewide Mutual Assessment Companies (if authorized under a preexisting law--Chapter 13). The author does not have information on similar plans in other states. Another type of operation is the State Life Insurance Fund of Wisconsin.

[2]This paragraph and the next are based on material in George G. R. Lucas and Ralph H. Wherry, <u>Insurance Principles and Coverages</u> (New York: Holt, Rinehart, Winston, 1954), pp. 30-31. Similar information is found in any standard insurance textbook.

[3]One of the continuing controversies in the life insurance field concerns the relative advantages of stock and mutual companies. Each position has strong support, but that particular question will not be covered in this study.

Considerable disparity in average size of the two kinds of companies is revealed in the fact that in mid-year 1972, of the 1,829 companies then in business, 1,676 were stock companies and 153 were mutuals. Yet the mutuals, which are generally older, had about two-thirds of the assets of the United States life companies, and slightly over half of the life insurance in force.[1]

Both types of companies perform similar functions, which can be classified in three broad areas: selling, servicing and investing. Among the professional skills needed are those of the actuary, the lawyer, the doctor and the accountant--plus, of course, the agents in the field. One standard text lists the following as the major functional areas through which a life insurance company operates: actuarial, agency, accounting and auditing, investments, law, underwriting, and administration.[2]

A distinctive characteristic of life insurance companies is the field organization, or agency force. In our nation today, most life insurance is not "bought," it is "sold." The customer does not seek out the agent, rather the agent seeks the customer--and may aggressively pursue him! Agents also render other services such as changes in insurance plans or beneficiaries, policy loans, assistance in preparing death claims.

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[1]Life Insurance Fact Book 1973, p. 91

[2]Huebner and Black, op. cit., pp. 653-4.

Most textbooks list two types of agency systems--the General Agency System, and the Branch Manager. A third way of writing (selling) life insurance is through a broker. The General Agent is an independent contractor who hires writing agents on such terms as he thinks best. His compensation is the difference between what he receives from the company and what he pays his agents.

The Branch Office, or manager's approach, is a newer system, but is growing in importance, especially among the larger companies. The branch manager is a salaried employee of the company who hires and trains writing agents. The manager may be paid a bonus either for increasing the amount of business or adding to the number of agents.[1]

Insurance may also be written through a broker. He holds contracts with several companies, and can place the business he writes where he sees fit. It is not uncommon for a General Agent to hold a brokerage license with another company which offers different kinds of policies, for example, health and accident insurance, or fire and casualty lines.

The various types of agents must all price their products as directed by their company. For this purpose a Rate Book is issued by each company with the exact price of each policy for each age group. The company has considerable

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[1]This information is based partly on Huebner and Black, op. cit., pp. 658-61, and partly on a conversation with E. Jay O'Keefe, President, Western National Life Insurance, Amarillo, on May 14, 1974, in Amarillo.

leeway in establishing those prices, however. Unlike fire and casualty rates, life insurance rates are not controlled by regulation. A company may vary its rate structure to try to make certain policies more appealing to particular age groups. Professor Joseph M. Belth of the University of Indiana, who has probably studied life insurance rates as extensively as anyone in the United States, makes this comment about company pricing actions:

> Life insurance literature in general, and actuarial literature in particular, abound with discussions of the various elements involved in life insurance pricing. Thus, extensive studies have been published concerning mortality rates, the effect of physical impairment and occupational hazards on mortality rates, methods of allocating divisible surplus among policyholders, and so forth. Conspicuously absent from the literature, however, are studies of the general price structure that has emerged as a result of the combined effect of the companies' practices with respect to each of the various elements of price.[1]

Macro Aspect

Just as there are distinctive characteristics of the firm, so are there of the entire industry. Table II-1 shows the estimated number of legal reserve life insurance companies[2] for selected years from 1759 to 1972.

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[1]Joseph M. Belth, The Retail Price Structure in American Life Insurance (Bloomington: Bureau of Business Research, Graduate School of Business, Indiana University, 1966), p. x.

[2]"A life insurance company operating under state insurance laws specifying the minimum basis for the reserves the company must maintain on its policies." Life Insurance Fact Book 1973, p. 121. See also p. 80 of this study.

TABLE II-1

NUMBER OF UNITED STATES LEGAL RESERVE LIFE INSURANCE COMPANIES, SELECTED YEARS, 1759-1972

Year	Number	Year	Number	Year	Number	Year	Number
1759	1	1850	48	1925	379	1963	1,490
1760	1	1860	43	1930	438	1964	1,552
1770	2	1870	129	1935	373	1965	1,635
1780	2	1880	59	1940	444	1966	1,712
1790	3	1890	60	1945	473	1967	1,725
1800	4	1900	84	1950	649	1968	1,775
1810	2	1905	126	1955	1,107	1969	1,787
1820	6	1910	284	1960	1,441	1970	1,801
1830	9	1915	295	1961	1,449	1971	1,805
1840	15	1920	335	1962	1,469	1972	1,810

Source: Life Insurance Fact Book 1973, p. 89.

The number of companies domiciled in each state is shown in Table II-2. Texas ranks second to Arizona in number of companies, with third-place Louisiana having a little less than half as many.

Despite the number of companies in the top three states, the insurance companies based in New York, New Jersey and Connecticut account for the greatest proportion of life insurance in Force.[1] As set out in Chapter I, this total was $1,627,985 million at the end of 1972, Of this, $87,069 million was in force in Texas.

Many Texas companies are active in other states, just as many "foreign" companies are active in Texas. The pervasiveness

[1]Life Insurance Fact Book, 1973, p. 90.

TABLE II-2

NUMBER OF UNITED STATES LIFE INSURANCE COMPANIES, BY STATE, MID-YEAR 1972 (Legal Reserve)

State	Number	State	Number	State	Number
Alabama	52	Louisiana	99	Oklahoma	54
Alaska	2	Maine	4	Oregon	8
Arizona	388	Maryland	16	Pennsylvania	66
Arkansas	27	Massachusetts	17	Rhode Island	5
California	54	Michigan	18	South Carolina	35
Colorado	30	Minnesota	24	South Dakota	8
Connecticut	12	Mississippi	16	Tennessee	20
Delaware	29	Missouri	42	Texas	219
D. C.	10	Montana	4	Utah	14
Florida	28	Nebraska	31	Vermont	4
Georgia	30	Nevada	2	Virginia	16
Hawaii	9	New Hampshire	3	Washington	22
Idaho	5	New Jersey	15	West Virginia	4
Illinois	93	New Mexico	5	Wisconsin	25
Indiana	55	New York	62	Wyoming	4
Iowa	27	North Carolina	22		
Kansas	22	North Dakota	11	Total U. S.	1,829
Kentucky	18	Ohio	43		

Source: Life Insurance Fact Book 1973, p. 90.

of State regulation makes the State a logical unit for analysis, yet much economic analysis of life insurance must deal with the industry as a whole.

A fundamental concern in analyzing the structure of an industry is its concerntration, that is, the extent to which a small number of companies account for a large proportion of an industry's output. The life insurance industry does not lend itself to the usual type of analysis of concentration because firm size is more commonly measured by assets or insurance in force than by output in a given year. Such measures will be used in the discussion that follows:

Fortune magazine publishes annually a list of the fifty largest life insurance companies in its directory of the largest non-industrial companies in the nation. The latest such list (July, 1974) includes three Texas companies: American National (Galveston), No. 24; Southwestern Life (Dallas), No. 29; and Southland Life (Dallas), No. 50. Texas Parade publishes a list of the top fifty life insurance companies in the State, with its latest list also being July, 1974. The information in the Tables below is taken from these publications (except as noted otherwise).

An additional measure of concentration was reported by one of the leading insurance publications in May of 1973:

> Ninety per cent or more of the new business written, the insurance in force and the assets of the life insurance business in the United States are in the hands of the 100 leading companies in each of these categories. In 1972, the 100 top companies issued $196 billion of new business; the 100 leaders in insurance in force had nearly $1.5 trillion of business on the books, and the assets of the first 100 totaled $228 billion.[1]

The study on which this article was based also revealed that of the $196.2 billion of new business issued (exclusive of increases, revivals, additions and reinsurance assumed) by the 100 leaders, 30 per cent was accounted for by the top five companies.[2]

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[1]"Leading Life Companies," Best's Review, Life/Health Insurance Edition, May 1973, p. 40.

[2]Ibid.

TABLE II-3

LARGEST UNITED STATES LIFE INSURANCE COMPANIES, 1973

Company and Location	Assets ($000)	Premium & Annuity Income ($000)	Life Insurance in Force ($000)[1]
Prudential (Newark)[2]	34,963,969	4,732,097	197,428,389
Metropolitan (New York)[2]	31,985,447	4,478,848	198,184,955
Equitable Life Assurance (New York)[2]	17,152,473	2,280,839	97,508,226
New York Life[2]	12,471,793	1,553,406	62,842,603
Top four	96,573,682	13,045,190	555,964,173
John Hancock Mutual (Boston)[2]	11,447,249	1,536,536	75,056,201
Aetna Life (Hartford)	8,933,987	2,010,617	71,506,611
Northwestern Mutual (Milwaukee)[2]	7,096,113	689,507	25,721,934
Connecticut General (Bloomfield)	6,622,110	1,231,069	41,428,713
Second four	34,099,459	5,467,729	213,713,459
Top eight	130,673,141	18,512,919	769,677,632
Top twenty	172,139,303	25,162,736	1,006,836,475
Top fifty	204,848,629	31,860,578	1,274,729,126
Industry total[3]	252,436,000	48,668,000	1,778,300,000

[1]The question may arise as to how a company can be solvent when Life Insurance in Force (a liability) exceeds Assets by such a great amount. The life insurance in force represents total future liabilities. Using the principle of the law of large numbers, the larger the number of separate, but like, risks combined, the less uncertainty there will be as to loss in a given period. Life insurance companies are required by the law of the state in which they operate to set up reserves; described as, " . . . that amount, which together with future premiums, interest and benefit of survivorship, will be sufficient, according to the valuation assumptions, to pay future claims." (Huebner and Blake, op. cit., p. 358).

[2]Mutual Company. Source: The Fifty Largest Insurance Companies," Fortune, July, 1974, pp. 116-117.

[3]Life Insurance Fact Book 1974 (galley proof); based on conversation with Barbara Felicia, Research and Statistical Services, Institute of Life Insurance, New York, July 22, 1974 (telephone).

TABLE II-4

LARGEST TEXAS LIFE INSURANCE COMPANIES
1973

Company and Location	Assets ($000)	Premium & Annuity Income ($000)	Life Insurance In Force ($000)
American National (Galveston)	1,583,873	216,138	11,251,565
Southwestern Life (Dallas)	1,255,037	148,424	6,534,946
Southland Life (Dallas)	594,226	95,299	4,256,008
Republic National (Dallas)	478,135	284,359	10,959,326
Top four	3,911,271	744,220	33,001,845
Great Southern (Houston)	392,292	40,231	2,462,300
American General (Houston)	298,906	52,837	2,655,123
Fidelity Union (Dallas)	272,668	61,794	3,724,566
Variable Annuity (Dallas)	247,722	63,839	9,210
Second four	1,212,588	218,701	8,851,119
Top eight	5,123,859	962,921	41,853,044
Top twenty	6,333,407	1,296,409	55,909,318
Top fifty	7,045,162	1,569,862	66,736,987
State Total	7,377,057	1,736,316	71,393,806

Source: "The Top Fifty Life Insurance Companies." Texas Parade, July 1974, p. 72. Also, Letters, Joe Christie, Chairman, State Board of Insurance, August 1, 1974 and August 22, 1974.

The purpose of examining such measures of concentration is to determine the effect on market behavior and market performance. This concern on the part of the public was expressing by a Washington attroney, addressing other attorneys who would be dealing with cases involving measures of concentration.

TABLE II-5

LIFE INSURANCE IN FORCE BY SIZE
CLASS OF LARGEST COMPANIES,
1973
($000,000)

Size Class	United States		Texas	
	Amount	Per Cent	Amount	Per Cent
Top 4	555,964	31.30	33,001	46.20
Top 8	769,677	43.30	41,853	58.62
Top 20	1,006,836	56.60	55,909	78.31
Top 50	1,274,729	71.70	66,736	93.47
Total	1,778,300	100.00	71,393	100.00

Source: Summary of Tables II-3 and II-4.

But how high is "high"? How high does concentration have to get before all these ill effects the Supreme Court has told us about will probably start to appear? How does one go at translating the theory into practice? Economists have spent a lot of time trying to identify the structural "boundary line" between effective competition and effective monopoly. The substance of their findings seems to be something like this: If a particular industry is sufficiently <u>un</u>concentrated that its four largest firms hold <u>no more than</u> about 40 per cent of its total sales, no competitive problems are likely to appear. Prices will tend to remain low, quality and service will tend to remain high, and all the other virtues of competition mentioned by the Court will tend to remain in evidence. If, on the other hand, the four largest firms in a particular industry or market account for <u>more</u> than 50 per cent, the probabilities start to go the other way . . . . Below that 40 per cent point on the 4-firm concentration scale, we tend to have pretty effective competition; above the 50 per cent point on it, the symptoms of monopoly tend to start showing up.[1]

[1]Samuel A. Smith, "Price Discrimination, Sales Below Cost, and Antitrust Vulnerability," <u>Antitrust Law and Economics Review 6</u> (Winter 1972-1973): 71-72.

Why should this be so? Economic theory tells us that economies of scale serve as a barrier to entry, and thus enable the firms in the industry to be more "monopolistic"-- to have greater control over price and output. One of the earliest studies of the effects of concentration was conducted by Professor Joe S. Bain, and published in 1954. It dealt specifically with selected manufacturing industries, but some of the principles enunciated have wider application. His study tended to show that, "If a plant or firm needs to supply only a negligible fraction of industry output to be reasonably efficient, economies of scale provide no deterrent to entry other than those of absolute capital requirements."[1]

If the life insurance industry "too" concentrated? Not "legally" according to the definition of lawyer Smith. But obviously there is a tremendous variation in size between the top few firms and the vast majority. Yet there are profitable firms in all size ranges. A recent study reported in the <u>Journal of Risk and Insurance</u>[2] concluded that the most profitable size for life insurance companies is probably in a range beginning at $100 million of annual premium income, and extending to the very largest companies. The author asked

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[1]Joe S. Bain, "Economics of Scale, Concentration, and the Condition of Entry in Twenty Manufacturing Industries," <u>American Economic Review</u> 44 (March 1954): 16.

[2]S. Travis Pritchett, "Operating Expenses of Life Insurance Companies, 1961-70: Implications for Economies of Size," <u>Journal of Risk and Insurance</u> 40 (June 1973): 157-165.

E. Jay O'Keefe, President of Western National Life Insurance Company of Amarillo, Texas, to comment. After discussing several factors affecting profitability, he stated:

> A research of history would probably disprove Professor Pritchett's optimum size beginning at $100 million of annual premium income. There must be several hundred companies which have reached profitability long before reaching this level, and maintained it thereafter. Western National's premium income for 1973 was a little over $16 million, and we have been operating at a profit for years. My conclusion is that it would be very difficult to pick a size as a rule of thumb.[1]

If there are no significant economies of scale to serve as barriers, a greater degree of competitiveness will exist. The situation postulated by Professor Joskow in the study previously cited would not prevail:

> Substantial cost advantages for the very large scale operations could indicate substantial barriers to entry and the possibility that large firms could set prices substantially above marginal cost without provoking competitive entry. At the same time the presence of a large number of small, high cost fringe firms may indicate that the large companies . . . have succeeded in keeping prices above the competitive level, thus protecting inefficient producers. This latter phenomenon will most likely occur only if entry at optimum size is difficult.[2]

If the situation described above did exist, an industry might normally be expected to be in violation of antitrust laws. Life insurance is partially exempt, however,

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[1]Letter, June 13, 1974.

[2]Paul L. Joskow, loc. cit., p. 384.

as will be described in the next chapter.[1] Some would justify this exemption on economic grounds, while others would explain it politically. Fritz Machlup is among the latter.

> Some vested interest groups have been able to persuade the Congress that they should be exempt from the antitrust laws because of the special circumstances prevailing in their industries or trades . . . .
>
> The case of insurance is especially interesting because the courts had long held that insurance was not a part of commerce and hence not covered by the antitrust laws. After the Supreme Court declared the insurance business was subject to the Federal antitrust laws (U. S. vs. Southeastern Underwriters Association, 322 U. S. 533 (1944)). Congress was high-pressured into passing a law exempting it again for all practical purposes.[2]

On this basis, perhaps Professor Machlup would agree in part with the conclusions of a study by Louis M. Kohlmeier, Jr., who wants to do away with regulatory agencies and rely on antitrust actions when consumers are not satisfied with the discipline of the market place, "Antitrust is, as regulation attempted to be, a political policy addressed to industrial economies. The policy of antitrust is to foster

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[1]One student of government regulation has stated: "There are certain collusive practices, such as agreements among insurers not to file lower rates and boycotts denying reinsurance privileges to those who do so, which can still be prosecuted under the Sherman Act. And mergers of insurance companies located in different states, being beyond state control, can probably be prevented under the Celler-Kefauver Act." Clair Wilcox, Public Policies Toward Business, 4th ed. (Homewood, Ill.: Richard D. Irwin, Inc., 1971), p. 610.

[2]Fritz Machup, The Political Economy of Monopoly; Business, Labor and Government Policies (Baltimore: The Johns Hopkins Press, 1952), pp. 212-13.

competition; the policy of regulation, formal or informal, is to suppress competion."[1]

As a regulated industry with firms of widely varying sizes, life insurance is obviously not of an atomistic nature. The few large firms might seem to indicate oligopoly, but the lack of effective barriers to entry (other than regulatory requirements), and the independent pricing policies rule this out. Thus, it seems clear that the market structure most closely conforms to <u>monopolistic competition</u> as first described by Edward Chamberlin. A key factor is indicated by Professor Peter Asch of Rutgers College, "The notion of monopolistic competition may be seen to follow from the observation that one particular market imperfection is almost universal: <u>product differentiation</u>."[2] Chamberlin had described this as follows:

> A general class of products is differentiated if any significant basis exists for distinguishing the goods (or services) of one seller from those of another. <u>Such a basis may be real or fancied</u>, so long as it is of any importance whatever to buyers, and leads to a preference for one variety of the product over another.[3]

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[1]Louis M. Kohlmeier, Jr., <u>The Regulators; Watchdog Agencies and the Public Interest</u> (New York, Harper & Row, Publishers, 1969), p. 294.

[2]Peter Asch, <u>Economic Theory and the Antitrust Dilemma</u> (New York: John Wiley & Sons, Inc., 1970), p. 39.

[3]Edward H. Chamberlin, <u>The Theory of Monopolistic Competition, A Re-orientation of the Theory of Value</u>, 7th ed., (Cambridge: Harvard University Press, 1956), p. 56. (italics added).

As will be brought out in the next section, the products of the life insurance industry are highly differentiated.

There are other characteristics of the life insurance industry which might be mentioned, but the above should serve to define it sufficiently so that its behavior and performance can be analyzed. Two relatively new developments will be mentioned, however, although it is too early to tell just what their impact will be.

One of these, which began around 1967, is the formation of insurance-oriented holding companies. According to Best's Insurance Reports-Life/Health, the purpose of this movement is to gain greater flexibility of operation. "These holding companies in some cases have established goals of meeting all the financial needs of their customers."[1] There is a danger that such an organization would allow companies to "move their assets around" and make effective regulation more difficult.

A related movement has been " . . . the establishment of relationships with mutual funds by more than 200 life insurance companies."[2] This has been motivated by a desire to "regain that portion of the consumer savings dollar that in recent years has gone into other forms of savings."[3]

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[1] Best's Insurance Reports, Life/Health 1973 (Morristown, New Jersey: A. M. Best Co., 1973), p. ix.

[2] Ibid.

[3] Ibid. See also p. 206 of this study.

Undoubtedly new patterns of organization will develop in the future. The life insurance business is often thought of as very conservative and slow to change because of the long-term nature of its contracts. Yet the volume of funds which it handles demands that it be ever alert to changing conditions in order to remain a viable part of the economy.

Behavior

Behavior, or conduct, is a very broad term, yet it can have much to do with the competitiveness of an industry. To some it may mean the vigor with which a firm's officers pursue a goal, and the nature of the goal--profit maximization, increased sales or a certain share of the market. To others it may mean a trade-off between quality and price. Or, as George W. Stocking uses the term in Workable Competition and Anti-trust Policy, it may mean:

> The strategy resorted to by a firm in seeking to protect an advantage it already has . . . . Strategy is the weapon of a firm operating in an imperfectly competitive market, but resort to strategy is not necessarily inconsistent with workable competition . . . . it may lead to improvement of processes and products . . . (or) it may serve to isolate a producer from the impact of competition . . . .[1]

Behavior can only be evaluated in the light of structure, and in turn it is reflected in performance. What are some of the unique behavioral characteristics of the insurance industry?

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[1] George W. Stocking, op. cit., p. 124-5.

Varieties of Policies

As mentioned above, the products of the industry are highly differentiated. Looking at the Texas companies alone, the tremendous variety of policy provisions would seem to indicate almost endless types of life insurance. All of them can be classified into one of three main types, however: term insurance, whole life, and endowment.[1]

Term insurance policies give protection for a "definite and limited period of time."[2] If death occurs during the policy period, proceeds are payable to the beneficiary. If the insured survives the term, the policy expires and the contractual relationship is terminated. There are many varieties of term insurance, and it is often used in combination with other types of insurance. There is a school of belief that this is the least costly form of insurance--and therefore the most desirable. In the 1973 session of the Texas Legislature a bill was introduced which, if passed, would have prohibited the sale of any other type of life insurance within the State.[3]

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[1]The following descriptions are adapted from Davis W. Gregg, ed., Life and Health Insurance Handbook, 2nd ed. (Homewood, Ill.: Richard D. Irwin, Inc., 1963), Chapters 4, 5, and 6.

[2]*Ibid.*, p. 37.

[3]Forrest C. Roan, Chief Clerk of Insurance Committee, House of Representatives, Interview, June 8, 1973, Austin, Texas.

A more prevalent type of insurance is whole life. Unlike term insurance, it provides permanent protection, and the insurer promises to pay the face value of the contract when the insured dies. According to the Life Insurance Fact Book, whole life contracts represent almost one-half of the life insurance in force in the United States.[1] This type of insurance is composed of ordinary or straight life contracts, under which premiums are paid for the balance of the insured's life; and limited payment contracts, under which premiums are paid for life, or until the expiration of a stated period, if the insured is living at that time.

The third general type is endowment insurance. It provides for the payment of the face amount of the policy upon the death of the insured within a specified period, and also for the payment of the face amount at the end of the period, if the insured survives. It is a "combination of savings and protection,"[2] as is the whole life policy, explained above, but has a greater emphasis on savings. The whole life policy has a greater emphasis on protection.

There is another set of classifications used which relates more particularly to the market than to the product. These categories are: ordinary life, group life and industrial life. Under this classification, ordinary life is a

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[1] Life Insurance Fact Book 1973, p. 27.

[2] Davis W. Gregg, op. cit., p. 63.

product sold to an individual, whereas group life is sold to an organization. Group life may be paid for either by the insured or the organization, or some combination of the two. Industrial life is of declining importance in our nation, though at one time it was quite significant. These policies are relatively small, but the distinguishing characteristic is that the premiums are usually collected weekly by agents at the homes of the policyholders rather than being paid monthly, or less frequently, by mail or bank draft.

These classifications reveal little of the almost endless varieties of life insurance policies. In Texas all policy forms must have the approval of the State Board of Insurance, and one member of the Board stated that "hundreds" come each week for approval.[1] Of course, many of these may be similar, or even identical. Mrs. Freda Pogue, the Chief Actuary of the Oklahoma Insurance Department, pointed out that much of the similarity arises because of the desire of a company to be "competitive." She stated that an agent will frequently make a copy of a policy issued by a competitor and send it to his home office with a request for a similar policy to sell.[2] Probably Texas agents follow a similar practice.

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[1]Durwood Manford, Interview, June 21, 1973, Austin, Texas. Not all of these are life insurance forms, as will be brought out in Chapter V.

[2]Mrs. Freda Pogue, Interview, August 6, 1974, Oklahoma City.

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[1]Durwood Manford, Interview, June 21, 1973, Austin, Texas. Not all of these are life insurance forms, as will be brought out in Chapter V.

[2]Mrs. Freda Pogue, Interview, August 6, 1974, Oklahoma City.

The extent to which a company can go in differentiating its product is illustrated in a pamphlet issued by Southwestern Life of Dallas, one of the largest Texas companies. Under the heading, "We Offer Help in 100 Ways" is the following list:

> For people in search of exactly the right protection Southwestern Life offers more than 100 modern, flexible plans. Plans for individuals. Families. Businesses. Employee Groups.
>
> Basic policies that provide cash for final expenses, monthly income for dependents, for full payment of the home mortgage.
>
> Educational policies for college.
>
> Retirement policies that guarantee a lifetime monthly income.
>
> A single family policy that insures father, mother and children.
>
> Business and estate protection plans.
>
> Annuity plans that guarantee a lifetime income.
>
> Employee benefit plans with a wide range of benefits to choose from.
>
> And if your search extends to mutual funds and variable annuities, we can still help. They are available through our agents who are registered representatives of Southwestern Management and Research Corporation, an affiliate company.[1]

When all the optional features are considered, the variety of life contracts must be very extensive. One leading authority in the life insurance field gives this explanation for such a variety, "There are many so-called specialty policies. These usually are designed to fit an elaborate

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[1]"Search," Southwestern Life Insurance Co., Dallas, Texas.

sales presentation, rather than perform a real service for the buyer."[1]

Such a proliferation of policy types will obviously be confusing to the customer. Elizur Wright, often called the "Father of Life Insurance" in the United States, wrote in 1873:

> It would be easy, for one possessing the gift, to write a highly comic chapter on the various schemes adopted by the companies to attract business and get ahead of each other . . . the business, a mixture of insurance and accumulation in all possible and ever variable proportions, was as incomprehensible to the simple customer as the marketman's sausage or the boarding-house keeper's hash. All the more for this reason was it susceptible of no end of tricks variations, short cuts and mirages.[2]

The situation which Commissioner Wright perceived continues today, in the sense that the insurance contract is complicated and difficult to understand. The average customer is unwilling, or unable, to take the time and effort to see exactly what the policy provisions mean. Robert Dorfman points out the results of such inability to make a reasoned choice:

> If the consumer has no basis for judging the satisfaction that a commodity will give him, or if he is easily misled, then he cannot be expected to attain the highest indifference curve that his budget permits, and no claim can be made for the efficiency of relying on consumer's choice. Indeed, there is likely to be a positive inducement to mislead consumers when

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[1]Joseph M. Belth, Life Insurance, A Consumer's Handbook (Bloomington: Indiana University Press, 1973), p. 180.

[2]Elizur Wright, Politics and Mysteries of Life Insurance (Boston: Lee and Shepard, Publishers, 1873), pp. 185-6.

> they are unable to appraise the quality or serviceability of commodities offered.[1]

Such a situation normally induces a demand for government intervention in the market. Professor Dorfman's analysis continues, "Society is likely to intervene in those markets either by requiring disclosure of information or by substituting the appraisal of competent judges for those of individual consumers."[2] This intervention can come in the form of government restriction on what can be sold, or on who is allowed to sell. Both are in evidence in the field insurance field.

The Hearings before Senator Hart's committee mentioned in Chapter I[3] have included much criticism of the industry for failure to provide needed information to consumers. The importance of this information was emphasized by the Federal Trade Commissioner, Mary Gardner Jones, speaking to the Life Office Management Association in 1970:

> There is no other industry where the need for complete, factual information is more vital than in the insurance industry. If a consumer misconceives the type of insurance coverage he thinks he is purchasing, his very livelihood can be threatened.

She stated that the industry's record in meeting its responsibilities had been "uneven," and further stated that

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[1]Robert Dorfman, Prices and Markets (Englewood Cliffs, New Jersey: Prentice Hall, Inc., 1967), p. 140.

[2]Ibid., p. 141.

[3]See pp. 12 and 13.

most state insurance regulatory authorities did not have the expertise and resources to provide adequate protection for insurance-buying consumers.[1]

The theoretical consequences of this inability of buyers to make reasoned judgements are described by J. Hirshleifer in discussing the costs of searching for information. He describes the typical situation as asymmetrical in that the seller knows the quality of the product, but the buyer does not. He says such a situation,

> . . . may lead to what is called "adverse selection" in insurance jargon. Suppose that buyers can only judge quality by the average level in the market. Then sellers with inferior products are encouraged to offer them for sale--while those with superior products are correspondingly discouraged . . . . (There is) a temptation to sellers to deliberately degrade the quality of the product in response to buyer ignorance.[2]

To the extent this might be done, there is some justification for governmental regulation and intervention. This regulation must deal with a market where there is not only a complicated product, but a number of market imperfections.

Market Imperfections

Based on Alfred Marshall's description, the foregoing analysis would seem to indicate clearly that the market

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[1]Mary Gardner Jones, quoted in Joseph Diamond, "FTC Official Hits Gyps in State Control," The National Underwriter, Life and Health Insurance Edition, October 10, 1970, p. 20.

[2]J. Hirschleifer, "Where Are We in the Theory of Information?" American Economic Review 43 (May, 1973): 37.

for life insurance is far from perfect; " . . . the more nearly perfect a market is, the stronger is the tendency for the same price to be paid for the same thing at the same time in all parts of the market . . . ."[1] In classical economic theory such a market would be characterized by: (a) a large number of buyers and sellers, (b) a homogeneous product, (c) free entry of firms into and exit from the industry, (d) perfect mobility of factors of production, and (e) perfect knowledge on the part of buyers and sellers. Obviously, there would be only one price in the market for each product.

Many persons are of the opinion that there are no price differentials in life insurance. While this may be true within a company (except for such things as quantity discounts for larger policies, or a differential based on the payment period), it is far from true within the market as a whole. From the published information on premiums some comparisons were made, and are summarized here. (It is not suggested that the premium is an exact representation of the cost, but it is used as an approximation.)

Companies whose rates reflected additional features, such as insurance paid-up at age 85, 90, or 95;[2] endowment

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[1]Alfred Marshall, Principles of Economics, 8th ed. (London: Macmillan and Co., Ltd., 1920), p. 325.

[2]Premiums for most "ordinary life insurance" are payable during the entire life of the insured (or to the age of 100).

TABLE II-6

COMPARISON OF PREMIUMS OF PARTICIPATING POLICIES ISSUED BY 137 COMPANIES AND NON-PARTICIPATING POLICIES ISSUED BY 143 COMPANIES
Ordinary Life Policy Per $1,000 on $10,000 Policy
Males, Age 35

Premium Per $1,000	Number of Companies: Participating	Number of Companies: Non-Participating
$15.00 - 15.99		3
16.00 - 16.99		3
17.00 - 17.99	1	27
18.00 - 18.99	2	74
19.00 - 19.99	3	33
20.00 - 20.99	5	3
21.00 - 21.99	16	
22.00 - 22.99	32	
23.00 - 23.99	43	
24.00 - 24.99	21	
25.00 - 25.99	4	
Total No. of Companies	137	143
Mean	$22.88	$18.47
Standard Deviation	1.17	1.31

Source: Best's Flitecraft Compend 1974 (Morristown, New Jersey; A. M. Best Co., 1974).

at 96; or waiver of premium in case of disability, were not included. As many of the Texas companies were in this category, no separate calculation was made for them. If discounts for larger policies were included, the variations would be much larger.

In comparing the life insurance market to the classical model a number of differences are apparent. There are a large number of buyers and sellers, but the product is highly differentiated. There may be perfect knowledge on the part of the sellers, but it is available to buyers only at considerable cost. As will be shown more explicitly in the next chapter, there are specific regulatory barriers to entry (including capital requirements). From the standpoint of mobility of factors of production, labor and capital are the most critical. Labor, in the form of agents, is continually moving into and out of the industry. The long-term nature of many insurance investments restricts the movement of capital very considerably.

With discriminatory pricing of a highly differentiated product, there is a great deal of non-price competition.[1] Is there price competition? The figures cited in Table II-6 above would seem to indicate that there is. Professor Belth states in one of his studies, "The author does not object to price differences. He does object, however, to the widespread ignorance about those price differences."[2] He further makes several suggestions for helping overcome this ignorance, but acknowledges that:

> Each . . . would involve substantial organizational problems, all stemming from the fact that it is impractical, if not impossible, to perform a reliable price analysis without the aid of an electronic computer and agents and buyers do not have ready access to such equipment.[3]

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[1]The newspaper and magazine advertisements listed in the Bibliography make this very clear.

[2]Joseph M. Belth, "A Report on Life Insurance," Research Report No. 4, Bureau of Business Research, Graduate School of Business, Indiana University, 1967, (Mimeographed) p. 92.

[3]*Ibid.*

As mentioned above, the premium paid may be regarded as the "price" of life insurance, but is is a very inexact measure of the "cost" to the consumer. A number of ways of determining the "true cost" have been proposed,[1] but none is satisfactory to all the industry and the regulatory authorities. The so-called "interest-adjusted" method is currently receiving the most support. William H. Abell, a former Chairman of the Institute of Life Insurance, writing in the January, 1974, issue of Insurance, states,

> In recent months the ALIA, the Institute and NAIC (National Association of Insurance Commissioners) endorsed the use of interest-adjusted cost index, until a better method of cost comparison was devised. This was at least a partial response to the consumer request for more realistic cost figures.[2]

In 1973, Arkansas began requiring the use of this index, and it is now (after two postponements) to be required in Texas beginning September 15, 1974.[3]

Each company will need to furnish the information to its agents--probably through an additional column in the rate book. It is not something the agent could calculate easily, as shown by the following exerpt from the Texas

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[1]Joseph M. Belth, The Retail Price Structure in American Life Insurance (Bloomington: Bureau of Business Research, Graduate School of Business, Indiana University, 1966), p. x. (This book contains a very extensive analysis of various ways of computing costs.)

[2]William H. Abell, "The Set of Our Sales," Insurance, January 1974, pp. 18-19.

[3]Orders No. 26809 and 27022, Texas State Board of Insurance.

State Board of Insurance <u>Order</u> No. 26809.

Section 4. INTEREST ADJUSTED COST COMPARISON INDEX DEFINED. (a) The interest adjusted cost comparison index for level premium plans of insurance shall be calculated by applying the following steps:

1. Select the 5 year, 10 year or 20 year period over which the analysis is to be made.
2. Determine the cash value (and terminal dividend, if any) applicable at the end of the period selected.
3. For participating policies, accumulate the annual dividends at 4 per cent interest compounded annually to the end of the period selected and add this accumulation to the result of step 2.
4. Divide the result of step 3 (step 2 for non-participating policies) by an interest factor that converts it into a level annual amount accruing over the period selected in step 1. If the period is 5 years, the factor is 5.633; if the period is 10 years, this factor is 12.486; and if the period is 20 years, the factor is 30.969.
5. Subtract the result of step 4 from the annual premium payable.
6. Divide the result of step 5 by the number of thousands of the amount of insurance to arrive at the Life Insurance Adjusted Cost Comparison Index.[1]

The use of such an index of cost is too new for its effects to be judged with any degree of accuracy. Prospective purchasers may not even ask for it, or it may become a crucial factor. Based on this study, the writer has found that there are reasons other than price for buying a particular policy which have been important in the past, and will continue to be so in the future. Among these, confidence in the agent and confidence in the company play an important part.

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[1]<u>Order</u> No. 26809, Texas State Board of Insurance.

As an indication of the relative interest in price and other factors when purchasing life insurance, an informal, unscientific poll was made of the 206 members of the Amarillo Rotary Club by means of the letter in Appendix A. Usable replies were received from 156 members, or 75.7 per cent. The replies are tabulated in Table II-7.[1]

These business and professional men were not particularly price- conscious. As shown in Table II-7, less than twenty per cent indicated price as a reason for purchase. It is entirely possible that some of those who checked the category "the provision of that particular policy," had price in mind, but it must not have been foremost in their thinking. A majority of those who checked the category "other" gave as their reason "need for additional coverage," or something similar.

TABLE II-7

REASONS EXPRESSED BY MEMBERS OF AMARILLO ROTARY CLUB FOR PURCHASING LIFE INSURANCE

Reason	Reason	Multiple Reasons Two	Three	Four	Total	Per Cent
The Cost	13	8	5	2	28	17.9
Policy Provisions	24	16	6	3	49	31.4
The Agent	21	10	5	3	39	25.0
The Company	2	8	5	3	18	11.5
Other	17	3	2	0	22	14.2
	77	45	23	11	156	100.0

[1]Some answers indicated more than one reason for purchase. They were counted as one-half, one-third, or one-fourth, respectively, for each reason, in order that the total answers would agree with the number of replies received.

The principal conclusion to be drawn from this seems to be that many life insurance customers are <u>not</u> primarily interested in price. Professor Belth said in this regard:

> Life insurance should never be purchased solely on the basis of price. It is vitally important that the insurance be fitted to the individual's needs, that the financial strength of the company unquestioned, and that the claims integrity of the company be beyond reproach.[1]

Confronted with such a situation, regulatory efforts might be more properly directed to other aspects of the business. There will be further elaboration of this point in Chapter VI.

It is also possible that consumers behave in this way because they lack knowledge about the product, and rely on the agent or the reputation of the company. Tibor Scitovsky calls this the "uniformed market," and lists it, together with economies of scale, as a means of restraining competition by limiting entry.

> A market is uninformed when the average buyer in the market has an incomplete idea of the goods or services he buys, and judges their quality not by his own standards but on the basis of advertising and indexes of quality. By indexes of quality, we mean trademarks; the reputation, size, nationality, and age of the manufacturing or distributing firm; inessential but eye-catching features of the good itself; the price of the good--in short, anything by which the uninformed buyer is likely to judge quality.[2]

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[1]Joseph M. Belth, "A Report on Life Insurance," Research Report No. 4, Bureau of Business Research, Graduate School of Business, Indiana University, 1967, (Mimeographed), p. 37.

[2]Tibor Scitovsky, <u>Welfare and Competition: The Economics of a Fully Employed Economy</u> (Chicago: Richard D. Irwin, Inc., 1951), p. 333-4.

This would seem to be a fairly accurate portrayal of the market for life insurance. Scitovsky comments further about competition in such a market:

> When, however, competition is restricted by the uninformed nature of the market, the price maker's behavior and the nature of restricted competition assume additional aspects . . . . First of all, . . . in the uninformed market there is a tendency for competing products to become similar to each other; second, advertising assumes special importance in the uninformed market and contributes to keeping the market uninformed; and finally . . . prices tend to become an index of quality in such markets, which in turn leads to price discrimination.[1]

In the insurance market advertising and other forms of non-price competition certainly take on special importance. They are extensively used. Prices may not generally be taken as an index of quality, but some agents whose products are priced higher than others are known to claim that as a mark of quality.

Problems of Cost Determination and Accounting

The sellers of life insurance, though generally much better informed than buyers, are far from having "perfect information" about the market, or even about their own costs. Life insurance companies face an even more complicated problem than that which Fritz Machlup says confronts all sellers:

> Quite apart from the problems of calculating the unit cost of production, the mere adding up of expenses to obtain a total cost figure contains many controversial issues. It may be easy to add

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[1] *Ibid.*, p. 398.

> the total outlays made over the lifetime of the firm; but if a shorter period is taken it is difficult to decide how much of the past outlays should be charged to the period in question, how much of the outlays during the period should be charged to future periods, and how much of the future outlays should be charged to the production of the given period.[1]

Many students of the industry have acknowledged the unique difficulty of determining costs of life insurance. A doctoral dissertation presented at the University of Wisconsin summarized some of the thinking as follows:

> The various cost components of an insurance rate are not as readily determined and measured by management for their marketing and pricing decisions as the situations of other industries. For the insurance firm, the determination of direct and indirect costs and losses is not merely an intellectual exercise in cost accounting, but involves highly subjective, and in some cases sophisticated, mathematical techniques which attempt to minimize the error on the decision making effort rather than pinpoint exact quantities and values.[2]

A doctoral dissertation at the University of Texas examined insurance accounting practices in greater detail, and illustrated the uniqueness of such practices by recounting the experience of a CPA with one of the large stock life insurance companies. He resigned three years after receiving his CPA, saying that "in order to make use of the accounting theory he had learned, it was necessary to seek employment

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[1]Fritz Machlup, The Economics of Sellers Competition (Baltimore: The John Hopkins Press, 1952), p. 17.

[2]Halim Iskander Bishara, "An Analysis of Insurance Company Financial Insolvencies and the Public Interest" (Ph.D. dissertation, The University of Wisconsin, 1961), p. 4.

somewhere other than in the life insurance industry."[1]

A textbook in life insurance accounting pinpoints one of the strange features of the established procedures:

> We find ourselves, for example, with an established method of annual statement accounting which says, in effect, that the new business of a given year represents a loss irrespective of the soundness of the business written. We know that this is not so, or we would not devote so much time and effort to our vital job of selling insurance.[2]

Sales Maximization as a Goal

In courses in principles of economics students are taught that maximization of profits is the primary goal of economic enterprise. More advanced study reveals additional motivating forces.

> Most marginal analysis of the equilibrium of the single firm rests on the assumption that the business firm attempts to maximize its profits. To make this assumption is not to deny that the men who run a business may be motivated also by other considerations.[3]

In the life insurance field the other consideration is primarily size--measured by the amount of insurance in

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[1]Dale Ellsworth Armstrong, "An Examination of External Financial Reporting Practices and Underlying Accounting Principles Applicable to Life Insurance Companies" (Ph.D. dissertation, The University of Texas, 1952), p. 17.

[2]Joseph C. Noback, Life Insurance Accounting (Homewood, Ill.: Richard D. Irwin, Inc., 1969), p. 302. This situation arises because it takes about $15 to $20 of surplus funds to put $100 of new business on the books. The bulk of the agent's commission is paid out of the first year's premium, fixed expenses must be paid, and unearned premium reserves must be set up as well as reserves to cover policy liabilities.

[3]Fritz Machlup, The Economics of Sellers Competition, p. 47.

force. Economists of various points of view have endorsed such a goal. Joan Robinson stated it this way:

> What is the aim of the entrepreneur . . . ? It is for the firm first to survive, and secondly to grow. To this end he must pursue profit, but he must avoid action which, though profitable in the present, will damage his future position . . . .[1]

Growth as a goal has also been supported by William Baumol.[2] His position has been endorsed by John Kenneth Galbraith, as explained in a recent article in Modern Age by Harold Demsetz:

> One of the more clearly stated of Galbraith's beliefs is Professor William Baumol's hypothesis that large corporations willingly sacrifice profits in order to grow more rapidly. This proposition plays a central role in the logic of the New Industrial State, because it provides a pattern of corporate behavior that is consistent with Galbraith's judgment that technostructure oriented firms increase output too rapidly.[3]

The tremendous effort which most companies put into selling would seem to bear out this hypothesis. And proper cost accounting for the new business, as brought out in the previous section, is very difficult. In the very short run a life insurance company can increase output significantly solely with an increase in selling expense. This is done

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[1]Joan Robinson, Collected Economic Papers, 2 vols. (Oxford: Basil Blackwell, 1964), 2:225.

[2]William J. Baumol, Business Behavior, Value and Growth (New York: The Macmillan Co., 1959), Chapter 6.

[3]Harold Demsetz, "Advertising in the Affluent Society," Modern Age 18 (Winter 1974): 16.

by most companies once or twice a year with a "Salute-the-President Month," or some similar promotion among the agents. The increased business will require use of additional surplus, and a little extra work in the home office. But the only other direct expense would be the prize for the winning agent or agents. This could be as expensive as a trip to the Company Convention, or as modest as a plaque to hang in the agent's office.

The contrast of such a situation with that found in other types of industry has been analyzed by Paul L. Joskow of M.I.T.:

> The comparison of sales concentration ratios for insurance firms with those for manufacturing enterprise probably overstates the relative degree of control of the firms in the insurance industry. Insurance firms can easily expand output in the short run with little or no increase in "capacity," and both output and capacity in the long run by obtaining more equity capital if such expansion is desirable to compete with a particular company which gets out of line in terms of price. Particular firms can vary output and "capacity" much more quickly and with less cost than could a steel or automobile firm.[1]

Specific Marketing Problems

There are some problems in making those sales, however, which are unique to life insurance. Perhaps the most pervasive is the cost of distribution of the product. The Seventy-Fifth Anniversary Edition of The National Underwriter contains a report of a speech by management consultant Peter Drucker on this point:

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[1]Paul L. Joskow, loc. cit., p. 381.

> You have the highest selling costs of any industry . . . . A hell of a lot of money spent in selling is always an indication of not thinking, especially when it shows that the demand is there . . . . What does all this in effect indicate? You have substituted selling for marketing. You have built up a huge selling staff, and you are getting marginal results. It is high pressure selling which is exactly what you don't need.[1]

Another problem peculiar to the industry is "twisting." This involves the efforts of an agent to induce a customer to drop the insurance he is carrying and take out a new policy with the agent's company. There is more involved here than there would be in selling a Ford to buy a Chevrolet. All the "Guides" of the Pennsylvania Insurance Department contain this warning:

> If you are going to switch policies (that is, drop one policy to pick up the policy of another company), you should be especially careful in making your decision.
>
> Many switches are not advantageous to the policyholder, and merely produce extra commissions for the agent.
>
> Regulations of the Pennsylvania Insurance Department require that before you switch policies, you get expert advice in writing from the agent involved so that the switch will, in fact, be advantageous. You should also discuss the proposed switch with the agent who sold you the policy.

The Texas Insurance Code 1969 prohibits, as an Unfair or Deceptive Act, the making of any derogatory statement about the financial condition of any insurer, or statement to injure any person engaged in the business of insurance.[2]

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[1]Reported in William Macfarlane, "Consumerism: No Longer a Non-Word," The National Underwriter, Seventy-Fifth Anniversary Edition, 1972, p. 224.

[2]Code, Chapter 21, Article 21.21, Section 4(3).

There are various reasons for such a rule. A person's age or condition may have changed so that the insurance would be more costly. The two-year period during which suicide is not covered may be a factor. Likewise, after two years the policy becomes incontestable.[1] And, most critically, the insured may not understand all the factors involved.[2]

A letter in The Wall Street Journal states that much of the insurance business of Equity Funding was of this nature:

> Long before its explosive collapse, Equity Funding was known as the prostitute of the life insurance business. Why? Because its sales were largely replacement sales. Their techniques preyed on the ignorance of policyholders . . . .[3]

The practice is universally condemned in the industry, but it crops out most often with representatives of new

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[1]"By this provision of the contract, the company agrees not to set up as a defense any error, concealment, misstatement or even fraud, on the part of the insured after the policy has been in effect a certain length of time." (Huebner and Black, op. cit., p. 168.)

[2]It should not be overlooked that proscription of twisting can be viewed as an anti-competitive device. It was so viewed in the Study under the auspices of the Temporary National Economic Committee in 1940. "In fact, many life companies have made a determined effort to eliminate competition among themselves . . . . The so-called replacement agreement to which the great majority of American companies have subscribed is another effort in this same direction in that the signatory companies have in effect bound their agents not to disturb for any reason insurance already in force in another company." (Investigation of Concentration of Economic Power, Monograph No. 28, "Study of Legal Reserve Life Insurance Companies." Senate Committee Print, 76th Congress, 3d Session, Washington: Government Printing Office, 1940, p. 235.)

[3]John M. Hazlett, Letter, The Wall Street Journal April 29, 1974, p. 9.

companies trying to compete with the "image"--and the well-trained agents--of the established companies.[1]

The industry suffers, as do some others, from deceptive and misleading advertising. In the case of life insurance the particular problem is with mail solicitation. The critical factor is that if a customer buys through the mail a policy from a company not licensed to do business in his state, he has little recourse in case of unsatisfactory service.[2]

Insurance companies, of course, face all the problems that any business encounters. Those listed above deserve special mention, however, because they are somewhat unique to this industry. To determine how well the industry meets these problems, and others, some analysis will be made of the results of the industry behavior, operating within its organizational structure.

Performance

Economists are concerned with the effectiveness with which an industry jusifies its existence. Many questions are

[1]These problems are outlined in a doctoral dissertation from the University of Pennsylvania. "Among the difficulties that a new insurance carrier faces are: competition from old established companies to obtain business; difficulty in writing the better class of risks; and competition for agents, with the resulting need to pay higher commissions than those paid by the old established companies." Archie John Nichols, "The Liquidation of Insurance Carriers in the Commonwealth of Pennsylvania" (Ph.D. dissertation, University of Pennsylvania, 1961), p. 2.

[2]The Deputy Commissioner of the Oklahoma Department of Insurance, Gerald Grimes, stated in an interview in Oklahoma City, August 6, 1973, that the greatest problem in this area is with companies domiciled in Pennsylvania.

asked concerning prices, profits, rate of innovation, evidence of monopoly activity, and overall benefits to society.

Benefits to Consumers and Society as a Whole

The literature of the life insurance industry is replete with references to its benefits to society. On the first page of statistics in the Life Insurance Fact Book is a listing, "Benefit Payments in the United States." The 1973 edition shows these figures for 1972:

Payments to Beneficiaries	$8,007,000,000
Payments to Policyholders and Annuitants	10,567,000,000
Total	$18,574,000,000
Health Insurance (paid by Life Companies)	9,675,000,000[1]

Statistics concerning the numbers of policyholders and amount of insurance were given in Chapter I of this paper.[2] An additional figure of interest is employment. During 1972 an average of 1,530,000 people were employed in the insurance business in the United States.[3]

The industry is naturally concerned with the prolongation of life and has supported much research in this field.

> The focus of individual company contributions and research grants has been in the areas of biomedical research, delivery of health care services, and preventive medicine . . . . A Medical Research Advisory

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[1] Life Insurance Fact Book 1972, p. 7.

[2] pp. 2-3

[3] Life Insurance Fact Book 1973, p. 96.

Committee has recently been established by the Association of Life Insurance Medical Directors of America in cooperation with the Institute of Life Insurance.[1]

Critics of the industry take an entirely different approach. In this field, as others, Ralph Nader has become a leading spokesman. He was called as the first witness before Senator Hart's Subcommittee in its study of life insurance in 1973, and listed the following points as an overview of "the findings of our present testimony." He did not make any statement about the process which led to these findings.

1. Life insurance tragically fails to sufficiently protect its ultimate consumers--the widows and children--from the financial risk of premature death of the breadwinner . . . .

2. Through deceptions and inadequate information, the life insurance industry dupes husbands into shortchanging their wives and children by buying too much of the wrong kind of insurance (or too little of the right kind) at excessive prices.

3. Because there is little or no communicated price competition, the high expenses of the life insurance industry--virtually all borne by the consumer--are a national disgrace.

4. The "quiet" concentration of economic power by this industry has been substantially ignored by Congress, by the academic community and by citizens who are mistakenly asked to believe that competition over agents and empty advertisements is value competition.

5. The SEC has bended to the will of insurance giants to block or delay accounting reforms that would put life insurance profit reports on an equal footing with other industries.

6. Criticism of the industry is responded to with collateral irrelevance, semantic nullities or

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[1] *Ibid.*, p. 105.

private attempts to remove academic critics from their teaching positions. Instead of rational argument, company or trade association spokesmen use pompous pointification or a kind of patronizing insurance patriotism with roots deep in the industry's chauvinistic past.

7. Vietnam veterans and other servicemen and women are being victimized by an on-going military-insurance interlock at the Veterans' Administration and the Department of Defense.[1]

Impact of Regulation

Several of these statements represent value judgments about which reasonable men may disagree. The point of most interest to economists it the matter of price competition. Are there the sort of "abuses" traditionally associated with monopoly--high prices and restricted output? Because of the difficulty of classifying costs, it is not really possible to say at what point on its average cost curve the industry operates. The expense of distribution (selling) is high, as noted, yet if this cost were substantially reduced, would output similarly decline? Again, the information is not available to answer this question. Overriding this whole question is the difficulty of ascertaining what costs really are--both to the company and to the consumer. Certainly continued study is needed.

The opposite side of the price question is perhaps a little more easily answered--has there been "cut-throat"

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[1]U.S. 93rd Congress, Senate, Committee on the Judiciary. <u>The Life Insurance Industry, Hearings Before the Subcommittee on Antitrust and Monopoly</u>. Cong., 1st Sess., 1973, p. 7.

competition which produces inferior products and drives firms out of business? No doubt there has been some, but the advances in actuarial science are helping to buttress companies against this danger. A report by the Staff of the Texas Legislative Council in 1954, listed the following as most frequent causes of insolvency (This study included life, fire and casualty companies, and covered all types of fraternal and mutual aid companies, which are a very insignificant portion of the industry):

Questionable Agency Balances
Abnormal commissions and allowances
Insufficient business volume
Possible falsification of cash and investments
Unauthorized withdrawals or use of funds
Questionable premium receivables[1]

A doctoral dissertation at the University of Texas in 1961 discussed life insurance company insolvencies under these headings:

Inept management
Improper management practices
Law violations
General lack of insurance knowledge
Bad faith by company management and agents[2]

While these studies may cover conditions which are not representative of the industry as a whole, there is little indication that "cut-throat" competition has been a major

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[1]Texas Legislative Council, "Insolvency in the Texas Insurance Industry, 1939-1954," Table XXV, p. 182.

[2]R. E. Thomas, "A Study of the Causes of Recent Texas Insurance Company Failures" (Ph.D. dissertation, University of Texas, 1961).

cause of company failure.

Impact of Regulation on Insolvency

Any company failure is a cause for concern on the part of regulatory officials. Some of the fault may lie with them as well as with the company. This section will consider the impact of regulation on insolvency. Even though recent legislation will mitigate adverse effects of company failure on policyholders; stockholders, creditors, and employees will suffer losses.

The whole question of insolvency is important in judging the performance of the industry. The State Commissioners have indicated their concern by sponsoring a study to devise more adequate early-warning tests of impending financial trouble.[1] The use of these tests should enable regulatory officials to detect much impending trouble before it reaches a stage sufficiently critical to cause insolvency. Thus, more regulatory effort can be devoted to prevention of company failure rather than to dealing with its aftermath.[2]

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[1]The National Association of Insurance Commissioners contracted with McKinsey & Company, Inc., to study all aspects of State regulation. One of their reports deals with such tests, "Improving the Life and Health Early Warning System," April 12, 1974. See also pp. 169-171.

[2]The Texas Insurance Commissioner, Clay Cotten, stated in an interview in Austin on June 21, 1973, that he had spent several years trying to work out the problems of Girard Life (see pp. 178-179, infra), and also a great deal of time with Century Life. Professor Belth described the latter situation and concluded, "Presumably the Texas Insurance Department did the best it could with a bad situation." Joseph M. Belth, Life Insurance: A Consumer's Handbook (Bloomington: Indiana University Press, 1973), pp. 177-8.

The cost accounting problems of the industry, coupled with the long-term nature of its obligations, make it difficult to determine actual solvency conditions. Professor Belth concludes the report of one of his studies with this summation, "It is impossible, at least in the absence of an effective crystal ball, to determine the amount of assets that a life company should possess at any given time in order that it will certainly be able to meet its future obligations."[1]

Innovations

Another traditional measure of industry performance--and the last to be considered here--is the rate of innovation. There are three aspects which might be considered: company administration and management, investment practices, and industry products. The first of these is not significantly different for the life insurance industry from the practices found in other industries, and will not be considered in this study.

Changes in our economy have spurred changes in both of the other aspects--perhaps more slowly than needed, but more than many have realized. There was a time when the industry, traditionally conservative in investment pattern, regarded common stocks as too risky. Prior to World War II,

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[1]Joseph M. Belth, "Observations on Solvency in the Context of Life Insurance Regulation," Journal of Risk and Insurance 34 (December 1967): 557.

such investments were prohibited in many states. From slightly more than two per cent of company assets in 1945, common stock investments had risen to over 11 per cent at the end of 1972.[1] Some of this increase has come at the expense of investment in real estate mortgages. In 1972 this form of investment had declined to thirty-two per cent of assets from a high of thirty-eight per cent in 1967.[2] There are new features in many of these investments, however:

> To an increasing degree, equity participations in the form of warrants or other profit-sharing arrangements (equity "kickers" in the jargon of the investment officer) are linked to bond and mortgage investments acquired by life insurance companies. The object is clearly to compete more effectively with mutual funds and private noninsured pension plans.[3]

Regulation has undoubtedly slowed this whole process--whether wisely or not is a value judgement which cannot be fully answered here. The existence of such regulation has in some cases stimulated structural changes in the industry.

> But not all legislators have moved fast enough to suit the more ambitious insurance companies. Stock companies like Aetna, Connecticut General and National Life and Accident of Nashville have found a solution in using the holding-company umbrella. The life company and the real estate subsidiary are no longer directly connected; both are now subsidiaries of the holding company. Since the real estate subsidiary is divorced from the life company, it is unregulated and can operate without interference from the insurance examiner.[4]

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[1]Life Insurance Fact Book 1972, p. 70.

[2]Ibid.

[3]Murray E. Polakoff, et al., Financial Institutions and Markets (Boston: Houghton Mifflin Co., 1970), p. 145.

[4]Sanford Rose, "The Future Largest Landlords in America," Fortune, July 1970, p. 134.

In the product line there have also been changes, with the variable annuity receiving the most attention. The increasingly close relationships between life insurance companies and mutual funds has already been mentioned. This relationship reflects the attempts of the industry to meet the problems of inflation, and to meet the competition of other savings institutions.

One study of innovation in the field concluded that, "The most common source of new products for a life insurance firm is an analysis of competitor's products, which means that the idea is new to the firm but not to the industry."[1]

To the extent that this is true, there will be little or no impediment from regulatory authorities. But genuine innovations will usually require regulatory approval, with its attendant delay. In the next chapter the history of this regulatory process will be reviewed, based on the industry characteristics which have created a demand for it. The groundwork will be laid for specific discussion of the Texas regulatory system in Chapter V.

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[1]William Rudelius and Glenn L. Wood, "Life Insurance Product Innovation," Journal of Risk and Insurance 39 (June 1970): 180.

CHAPTER III

HISTORY OF INDUSTRY REGULATION

The previous chapter has examined the structure, behavior and performance of the life insurance industry. During the discussion, numerous references were made to the regulation of the industry. Therefore, this chapter will consider the characteristics which created a demand for regulation, and examine briefly the early forms in which it was expressed. Following a survey of the changing legal basis for regulation, two investigative activities which had a significant impact on the industry will be examined: the Armstrong Investigation of 1905 in New York, and the study conducted by the Temporary National Economic Committee in 1939 and 1940. The present elements of State regulation will be listed, and the chapter will close with a consideration of some of the issues in the continuing controversy between advocates of State and Federal regulation.

Characteristics Which Created A Demand for Regulation

In a very broad sense, regulation in any industry comes about when the discipline of the marketplace does not produce results which are satisfactory to a sufficient body of consumers. The dissatisfied group may be large or small, but must have enough interest--and influence--to substitute some form of political (administrative) decision-making for that which the market would create. Professor Kahn identifies this segment of the economy in the following way:

> There are at least two large chunks of the economy that the competitive model obviously does not describe or even purport to describe. These are the huge and growing public sector, the allocation of resources to which is determined not by the autonomous market but by political decisions, and the public utilities, in which the organization and management is for the most part (in the United States--not in most other countries) private but the central economic decisions are subject to direct governmental regulation.[1]

With rather limited exceptions[2] the life insurance business is in the regulated category, yet it is not usually considered to be a "public" utility. The boundaries of public utilities are not rigidly fixed, but they are generally assumed to include: (1) local and interregional transportation, (2) light and power generation and distribution, (3) telephone service, and (4) municipal facilities for water and sanitation. The public utility status imposes

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[1]Alfred E. Kahn, op. cit., 1:2.

[2]In 1911, the State of Wisconsin, in order to provide low-cost insurance, and a "yardstick" for regulation, set up a State Insurance Fund. It has never become a large operation, and has not been copied. (Spencer L. Kimball, Insurance and Public Policy (Madison: University of Wisconsin Press, 1960), p. 58). The various programs of the Federal Government for military personnel, though large in dollar amount, are a very small proportion of the life insurance business. These and the Federal Social Security program are outside the scope of this study.

certain obligations: (1) to serve all in the market area who desire service and are willing to pay for it, (2) to render adequate service in a safe manner, (3) to serve all customers without undue discrimination, and (4) to charge only a "fair" price. The public's need for these services constitutes a justification for limiting entry and controlling rates.[1]

Radio and television services are sometimes included in the public utility category, as these industries are closely regulated, although regulation of these services does not impose all of the above obligations.

Spencer L. Kimball, writing in 1969, said some of the regulatory developments ". . . gave an indication of how little difference remained between insurance and the classic public utilities." However, he said the process of development in this line, ". . . was not yet complete in mid-twentieth century."[2] At the three-quarter century mark it is still not complete.

One difference is the absence of a legal obligation to supply its product to all who demand it (although there is an approach to this in states where automobile insurance is complusory). Another difference is the lack of a "need"

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[1]Among recognized works dealing with public utilities are: Elmer E. Smeed, Governmental Promotion and Regulation of Business (New York: Appleton-Century-Crofts, 1969), and Clair Wilcox, Public Policies Toward Business, 4th ed. Homewood, Ill: Richard D. Irwin, Inc., 1971.

[2]Spencer L. Kimball, op. cit., p. 305.

test for the chartering of a life insurance company. A former Insurance Commissioner of Wisconsin describes this very clearly:

> Some states have, it is true, attempted to use the need for a new insurer as a criterion in deciding whether to allow a new company to be admitted. But no insurance law that I know of gives the commissioner the right to deny a license to an insurer on the grounds that the people of the state are already adequately served in that branch of insurance and that there is no need for a new company. It should be noted that this criterion, so far inapplicable to insurance, is one of the prime bases used for denying permission to organize a new bus line, electric company or other public utility in most parts of the country. Even in banking, a branch of business which shares many of the financial characteristics of insurance, a new bank may not normally be opened in a given community unless there seems, in the view of the authorities, to be a need for it.[1]

Perhaps the greatest difference between regulation of public utilities and of life insurance companies is lack of rate control. For this reason control is exercised through different channels, and the public is perhaps less aware of the controls which are exercised.

The special position of the life insurance industry was recognized as early as the middle of the last century in England.

> The nineteenth century efflorescense of laissez-faire seemed to divest chartered enterprise of its fundamental identification with the public interest. But the belief persisted--if anything, grew--that the business of insurance had special responsibilities. An English parliamentary committee decided in 1853

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[1]Allen L. Mayerson, "An Inside Look At Insurance Regulation," Journal of Risk and Insurance 32 (March 1965): 56.

> that the public function of insurance transcended the generally accepted principle of (governmental) non-intervention in matters of trade.[1]

Various reasons have been advanced to support the reasons for this special consideration. In a 1945 book which is very favorable--almost laudatory--to the life insurance industry, the trust, or quasi-fiduciary concept was outlined:

> Even if we consider a single company, one of many, the financial hopes, the financial salvation of hundreds of thousands or even millions of persons depend upon the integrity and competence of its directors and officers . . . .
>
> Security is not due solely to the nature of the business (i.e. actuarial and investment principles commonly followed); ignorance, cupidity and mismanagement have in the past wrecked more than one company. But gradually there has developed on the part of life insurance directors and officers a trust fund conception of the nature of the business which is one of the main reasons for the safety it enjoys.[2]

The behavior of the industry in the way it charges for its products helps to explain this concept. The use of a level premium builds up an excess of dollars above current protection (mortality) costs during the early years of a policy. These must be adequate to make up the difference in later years when costs of protection are greater because of higher mortality rates. Sometimes this money is said to be

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[1]Morton Keller, The Life Insurance Enterprise, 1885-1910. A Study in the Limits of Corporate Power (Cambridge: The Balknap Press of Harvard University Press, 1963), pp. 5-6.

[2]Albert W. Atwood, The Great Stewardship. A Story of Life Insurance (New York: Harper and Bros., 1945), p. 135.

held in a quasi-fiduciary capacity. Spencer L. Kimball, whose studies and writing in the field are very extensive, states that there is no sort of "trust" involved, however. "There is nothing but an ordinary debtor-creditor relationship, just as in most contractual relationships."[1]

Other characteristics of life insurance sometimes cited as justifications for control are the long-term contracts, the complexity of the contracts and the large sums of money involved. None of these is sufficient in itself to evoke the comprehensive regulations in existence throughout the nation, but neither can any of them be overlooked.

Former Chief Justice Hughes stressed the long-term nature of the insurance contract in one of his addresses:

> Ordinarily when a man buys an article or commodity of some kind he is not particularly concerned if the company that sells it subsequently fails. But when he buys life insurance he pays premiums over a period of years, often a protracted period of years. Thus, the safety of the company is of paramount importance to him, because the benefits he receives are all in the future.[2]

The complexity of the insurance contract was illustrated in the previous chapter with a listing of the many types of policies. Anyone who has read a life insurance policy form will acknowledge the difficulty of understanding

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[1]Spencer L. Kimball, "The Regulation of Insurance," in Insurance, Government and Public Policy, Spencer L. Kimball and Herbert S. Denenberg, eds. (Homewood, Ill.: Richard D. Irwin, Inc., 1964), p. 4.

[2]Albert W. Atwood, op. cit., p. 7.

all its provisions. One basic life insurance text describes the problem in this way:

> Since the insurance product is a contract, by its very nature it is technical. In most cases the insured is asked to purchase a product in which he becomes a party to a contract which he has not read, and which he would not understand if he did read it. The complicated nature of most insurance contracts makes them appear to be formidable objects to the public, but this is so simply because as contracts, they are enforceable by law and must be precisely drawn. If the insurance company wishes to insure against loss by a specified peril, it must make certain that the contract limits coverage to that peril. In order to do this, it is often necessary to devise a complicated document.[1]

It may logically be assumed that the insured is less knowledgeable about the contract provisions than the company which had them prepared. A desire to protect him may well serve as an additional justification for regulation.

In the last chapter the listing of assets of some of the larger companies gave a clear indication of the amount of money involved in life insurance. Spencer Kimball pointed out in 1960 that these sums could not be ignored.

> In mid-twentieth century, the law faced new problems arising out of the growth of the business. There was vast increase in insurance company assets. How to regulate the investment of such assets without distorting the financial structure of American business was a new problem for the law. Pressure of such assets encouraged a relaxation of the investment regime from strict limitation to fixed-dollar investments toward greater freedom to invest in equities.[2]

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[1]Emmett J. Vaughn, General Insurance Fundamentals (Iowa City, Iowa: Sernol, Inc., 1965) p. 57.

[2]Spencer L. Kimball, Insurance and Public Policy, p. 308.

From the administrative viewpoint, a study published in 1927, which was long regarded as the seminal work in the field, stated:

> The insurance business is peculiarly one "affected with a public interest," in that it combined with vast opportunities for social welfare, exceptional opportunities for abuse. It has the glittering lure of "easy money" for the unscrupulous and adventurous promoter, and the mystery of an unknown technique for the unwary insurant. That the activities of the commissioner kept out many a small and unsound insurance enterprise, many a dishonest or an incompetent agent or broker, can scarcely be doubted.[1]

These reasons have been combined in various ways by legislative bodies to justify insurance regulation. Yet the statement of William Jennings Bryan, speaking to the National Convention of Insurance Commissioners in 1914, serves as a good summary:

> There is a principle in insurance that is . . . fundamental . . . and that is security is the one thing that is important above all others . . . All the efforts of the State are directed toward the security of the insured . . . .[2]

Early Regulation

Long before these special provisions came into effect, however, there was some type of regulation. The very earliest was through provisions of the company's charter. In 1795

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[1]Edwin W. Patterson, The Insurance Commissioner in the United States. A Study in Administrative Law and Practice (Cambridge: Harvard University Press, 1927), p. 12.

[2]William Jennings Bryan, "The Purposes of Insurance Regulations," in Insurance, Government and Public Policy, Kimball and Denenberg, op. cit., p. 19.

certain restrictions on investments were placed in the charter of the Insurance Company of North America. In 1799 the State of Massachusetts, in a re-incorporation charter, required the publishing of financial condition, and made the common stock assessable if losses exceeded capital. The charter of Aetna Insurance Company in Connecticut in 1819 contained restrictions on investments and prescribed certain corporate activities such as election of directors and rules concerning the annual meeting.[1]

Gradually these charter provisions gave way to special legislation; sometimes as part of overall corporation regulation, and sometimes directed specifically to insurance problems. As brought out by Morton Keller's extensive study, "(There was) a flow of legislation, especially in the West and South, from 1895 to 1903 . . . . But the practice of state control did not necessarily put these instruments to effective use.[2]

The first general life insurance law was passed in New York in 1840. It pertained to amounts of insurance which could go to a widow free from claims for creditors, and to certain rights of children.[3] The first states to create

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[1]These items taken from original sources are cited in Peter Robert Kensicki, "History of Insurance Regulation in Ohio, 1804-1879" (Ph.D. dissertation, Georgia State University 1972), p. 30. Other significant actions are listed under "Historic Dates," in Life Insurance Fact Book, 1973, p. 112.

[2]Morton Keller, op. cit., p. 199.

[3]Life Insurance Fact Book, 1973, p. 112.

supervisory agencies through boards of Insurance Commissioners were New Hampshire (1851) and Massachusetts (1852).[1] The New York Department of Insurance was created in 1859," . . . but did not have the vigor that Elizur Wright bequeathed to Massachusetts supervision."[2] Mr. Wright, who had been appointed one of that State's Commissioners, was a former abolitionist. Apparently he put the vigor of his former cause into this new field, for he was subsequently forced out of his position by pressure from those in the industry who favored more lenient regulation.

From the end of the Civil War till the turn of the century there were increasing efforts of the states to regulate the insurance industry. Yet they were frustrated in many instances through political power, outright bribery and incompetence.

> Supervisory challenges from Texas, Kansas and Wisconsin most keenly tested the companies' political prowess. Under the influence of Texas Populist Governor James S. Hogg, insurance commissioner John E. Hollingsworth attacked "the present craze for volume" in 1893 and declared that "the trend of insurance legislation of late years has been in the interest of the premium receiver rather than the premium payer." Charles A. Cullberson, Hogg's successor and no Populist, nevertheless inherited his predecessor's hostility toward the Eastern insurance firms. In 1896, in the wake of Bryan's defeat, he sent off a questionnaire asking companies for data on their officers salaries, their political contributions and their dinner and wine costs.

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[1] Davis W. Gregg, ed. Life and Health Insurance Handbook, 2nd ed. (Homewood, Ill.: Richard D. Irwin, Inc., 1964), p. 1075.

[2] Morton Keller, op. cit., p. 200.

The Mutual refused to answer--"This is insult. It is tyranny," McCurdy (Richard D. McCurdy, President, Mutual Life Insurance Co. of New York., 1885-1906) blustered--and, in harness with the Equitable, engaged former Governor Hogg himself as counsel.[1]

Legal Basis for Regulation

The influence and attention of the companies was focused on the states because of a decision of the U. S. Supreme Court in 1869, Paul v. Virginia.[2] Samuel B. Paul was attorney in Virginia for the New York Underwriters Agency, which was writing insurance in many states. The Company instructed Mr. Paul not to comply with a Virginia law which required that both a company and its agents soliciting business secure a State license. Mr. Paul was indicted, convicted and fined $50. The conviction was upheld in the State Supreme Court and in the United States Supreme Court on the grounds that insurance was not commerce, but a local transaction to be covered by local laws.

This decision stood for seventy-five years, during which time the rights of states to regulate various business activities was strengthened. Among the key cases generally cited are the following:

Munn v. Illinois.[3] This case is often thought of as the foundation on which much public regulation legislation has been constructed. Chief Justice Waite cited the English

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[1]Ibid., pp. 210-11.

[2]8 Wall. 168 (1869).

[3]94 U.S. 113 (1876).

common law doctrine of "private property affected with a public interest" as a basis for this decision.[1]

German Alliance Insurance Company v. Lewis, Superintendent of Insurance of the State of Kansas.[2] By this case (fire) insurance companies were specifically held to be "affected with a public interest" and thus subject to State control. Justice Kenna, for the majority, said:

> Is the business of insurance so far affected with a public interest as to justify legislative regulation of its rates? . . . We have shown that the business of insurance has very definite characteristics, with a reach of influence and consequence beyond and different from that of ordinary business . . . .[3]

U. S. v. South-eastern Underwriters Association.[4] Following this line of reasoning, it was generally believed that insurance was exempt from the provisions of the Federal anti-trust statutes. It became common practice for fire insurance companies, through their trade associations, to agree on common rate schedules. Then, in 1942 the Department of Justice secured an indictment against the South-eastern Underwriters

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[1]"This brings us to inquire as to the Principles upon which this power of regulation rests, in order that we may determine what is within and what without its operative effect. Looking, then, to the common law, from whence came the right which the Constitution protects, we find that when private property is "affected with a public interest, it ceases to be juris privati only." This was said by Lord Chief Justice Hale more than 200 years ago in his treatise De Portibus Maris, 1 Harg. Law Tracts, 78, and has been accepted without objection as an essential element in the law of property ever since." 94 U.S. 113, 125-6.

[2]233 U.S. 389 (1914).

[3]233 U.S. 389, 406,414.

[4]322 U.S. 533 (1944).

Association (which included 198 stock fire insurance companies) on the grounds that this Association (acting as a rating bureau) constituted a combination in restraint of trade.

The Association (and the individuals included) were indicted for two alleged violations of the Sherman Antitrust Act; (1) a conspiracy to restrain interstate commerce by fixing and maintaining arbitrary and non-competitive premium rates on fire and allied lines of insurance (Section 1), and (2) conspiracy to monopolize trade and commerce in the same lines of insurance in and among the same states.

Justice Black acknowledged that the Court had upheld Paul v. Virginia[1], but pointed out that those cases had upheld State statutes, whereas the present case involved an Act of Congress. His opinion recognized the basis on which the District Court had acted:

> Looking at all the transactions charged, it felt compelled by previous decisions of this Court to hold that despite the interstate character of many of them, "the business of insurance is not commerce," and that as a consequence this business, contracts and all, could not be "interstate commerce" or "interstate trade."[2]

Justice Black further elaborated on the concept of "commerce" and the intention of Congress in the Sherman Act:

> Ordinarily courts do not construe words used in the Constitution so as to give them a meaning more narrow than one which they had in the common parlance of the times in which the Constitution was written. To hold

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[1] Hooper v. California, 155 U.S. 648, 654, 655 (1895). New York Life Insurance Company v. Deer Lodge County, 231 U.S. 495, 503-4, 510 (1913).

[2] 322 U.S. 533, 537.

> that the word "commerce" as used in the Commerce Clause does not include a business such as insurance would do just that . . . .
>
> We come then to the contention, earnestly pressed upon us by appellees, that Congress did not intend in the Sherman Act to exercise its power over the interstate insurance business.
>
> Certainly the Act's language affords us no basis for this contention.[1]

Justices Reed and Roberts did not take part in the hearing or the decision of this case, and it was decided by a "majority" of four. Chief Justice Stone wrote a dissenting opinion, with Justice Frankfurter concurring substantially, but Justice Jackson disagreed partially in his dissent. Thus, this case, which changed seventy-five years of practice and belief in the industry, was itself the subject of considerable difference of opinion. Yet the decision was binding, and precipitated new legislation for control of the insurance industry.

During the time the South-eastern Underwriters case was in the Courts, there was considerable activity in the industry directed at the Congress. Bills were introduced which would have exempted the insurance industry from the provisions of the anti-trust laws, but none passed in that form.[2] Others sought exclusive State jurisdiction. The objection to this approach is outlined by Elmer E. Smeed:

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[1] 322 U.S. 533, 539, 553.

[2] Emmet J. Vaughan, op. cit., p. 59.

> An important obstacle, however, was the widespread distrust of the ability and inclination of the states to regulate effectively. This skepticism was strengthened by the fact that the states in the South-eastern Underwriters case had not, for many years, controlled a monopolistic concentration of economic power which was extremely predatory in its conduct. As a result, Congress did not go the whole way; new legislation provided that the federal antitrust laws should apply to insurance "to the extent that such business is not regulated by State law."[1]

The bill which finally passed was drafted by the National Association of Insurance Commissioners.[2] It was submitted to a conference committee as a compromise between those who advocated complete exemption from the antitrust laws (the House bill), and those supporting substantial regulation (the Senate bill).[3] This was the McCarran-Ferguson Act, Public Law 15, Seventy-ninth Congress, 1st Session. It became law on March 9, 1945.

The key provision was the so-called "moratorium" to give the states time to enact adequate regulatory legislation. Sec. 2(b) provided, in part,

> That after January 1, 1948, . . . the Sherman Act, . . . the Clayton Act, . . . (and) the Federal Trade Commission Act, shall be applicable to the business of insurance to the extent that such business if not regulated by law.[3]

President Roosevelt, in giving his approval to the bill, stated his position about the moratorium:

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[1]Elmer E. Smead, Government Promotion and Regulation of Business (New York: Appleton-Century-Crofts, 1969), pp. 79-80.

[2]Emmett J. Vaughan, op. cit., p. 59.

[3]Public Law 15, 79th Congress, 1st Session.

> It is clear from the legislative history and the language of this act, that the Congress intended no grant of immunity for monopoly, or for boycott, coercion, or intimidation. Congress did not intent to permit private rate fixing, which the Antitrust Act forbids, but was willing to permit actual regulation of rates by affirmative action of the states.
>
> This bill is eminently fair to the states. It provides an opportunity for the orderly correction of abuses which have existed in the insurance business and preserves the rights of the states to regulate in a manner consonant with the Supreme Court's interpretation of the antitrust laws . . . .[1]

The question arises as to the "extent" to which State law must go to conform to the provisions of Public Law 15. This has been answered in the courts: the effectiveness of state regulation is not to be considered. The enactment of a regulatory statute is sufficient.[2]

This survey of the legal basis for regulation has dealt with the framework only. The brief references to political and economic power and pressure cover actions which were lauded by some and deplored by others. Prior to the passage of the McCarran-Ferguson Act there were two occasions when interest in the life insurance industry captured national atttention: The Armstrong Investigation in 1905, and the investigation under the auspices of the Temporary National Economic Committee in 1939 and 1940. The circumstances

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[1]Franklin D. Roosevelt, The Public Papers and Addresses of Franklin D. Roosevelt, 1944-45 Volume, (New York: Harper & Bros., 1950), p. 587.

[2]American Hospital & Life Insurance Co. v. FTC, 243 F. (2d) 719 (1957); National Casualty Co. v. FTC, 245 F. (2d) 883 (1957); affirmed, 357 U.S. 560 (1958).

surrounding these two investigations will be considered, as evidence of areas of conflict which have arisen around the industry.

The Armstrong Investigation, 1905

The Armstrong Investigation marked a real turning point, both in regulatory actions and insurance company operations. Prior to that time the larger firms in the industry, while generally regarded as sound and conservative, were heavily involved in financial power politics. Subsequently, though subject to greatly intensified regulation, they grew to record size in assets and business in force.

The biographer of Charles Evans Hughes, Chief Counsel for New York State Senator Armstrong's committee, described the earlier practice in these colorful terms:

> It was a triangular arrangement. The "interests" controlled the bosses by paying them "boodle"; the bosses controlled the legislature by use of this money in campaigns; and the legislature protected the "interests" in their exploitation of the public.[1]

A study published in 1965 states that assets of U. S. insurance companies doubled between 1890 and 1900, and that "This expansion was achieved by a ruthless drive for more and new business, in the course of which the best interests of policyholders were forgotten."[2] One of the

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[1]Merlo J. Pusey, Charles Evans Hughes, 2 vols. (New York: The Macmillan Co., 1951), 1:162.

[2]George Clayton and W. T. Osborn, Insurance Company Investment, Principles and Policy (London: George Allen and Unwin, Ltd., 1965), p. 192.

keys to the situation was, according to Spencer L. Kimball, " . . . the intricate network of interlocking directorates by which large financial institutions exercised control of much of American economic life."[1] This led to a "fractionalizing" of interest. For example, there was a divided loyalty and sense of obligation on the part of a director who served both a life insurance company and the bank in which its account was kept, or the investment company through which it purchased bonds. "This involvement was in sharp conflict with the industry's need for sound and conservative management of what were essentially trust funds."[2]

Excellent accounts of the Armstrong Investigation are given by Shepard B. Clough[3] and Martin Keller.[4] A more personalized account is found in the biography of Charles Evans Hughes by Merlo J. Pusey.[5] What began as an internal difference among the management of Equitable Life spread to the entire financial community,[6] and led to a full-scale

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[1]Clarence L. Kimball, Insurance and Public Policy (Madison: The University of Wisconsin Press, 1960), p. 309.

[2]Ibid.

[3]Shepard B. Clough, A Century of American Life Insurance: A History of the Mutual Life Insurance Co. of New York, 1843-1943 (New York: Columbia University Press, 1946), Chap. XII.

[4]Op. cit., Chapter XV.

[5]Op. cit., Chapter 15.

[6]"The fight for the control of Equitable, in short, was a major battle in a bigger war, the biggest war there was in the banking and railroad world . . . the railroad fight between Messrs. Harriman and Morgan for the control of the Northwestern transcontinental railroad companies." (Mark Sullivan, Our Times, The United States 1900-1925, 4 vols. (New York: Charles Scribner's Sons, 1930), vol. 3, Pre-War America, p. 42.

investigation under the Chairmanship of State Senator Armstrong, and largely dominated by Chief Counsel Charles Evans Hughes.

> From the beginning (Hughes) made it clear that his primary concern was with the organization and government of the companies, with their structure and nature as corporate institutions. He recognized that this, rather than individual acts of wrongdoing was the source of the public's unease.[1]

The Report of the Committee in February, 1906, recommended specific remedial legislation, including proposals:

1. Relating to the organization of companies, election of directors, and conversion of stock into mutual companies.
2. Limiting the right to hold real estate, prohibiting investment in stocks, and forbidding syndicate participating in security transactions.
3. Limiting the amount of new business, expenses of operation, and amount of surplus and contingency funds that may be accumulated.
4. Forbidding tontine[2] dividend plans by requiring that mutual insurance companies must distribute surplus annually and not otherwise.
5. Dealing with the contents of policy forms and the rights of policyholders.
6. Prescribing the detail to be reported in annual statements.[3]

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[1]Merlo J. Pusey, op. cit., p. 252.

[2]An arrangement whereby a group of persons share certain benefits or advantages on such terms that upon the death or default of any member a part or all of the advantages enjoyed by him are distributed among the remaining members until on the death of all but one the whole goes to him, or, as in most modern insurance tontines, on the expiration of a given time (called the tontine period) the whole goes to those then remaining in the group. (Webster's New International Dictionary, 2nd ed., (1968), s.v. "tontine.")

[3]Report of the Joint Committee of the Senate and the Assembly of The State of New York, Appointed to Investigate the Affairs of Life Insurance Companies, in Exhibits, Reports and Index of Legislative Insurance Investigating Committee (Albany, 1906), Vol. VII.

stimulated similar legislation in many other states. New Jersey, the home of Prudential, conducted a similar investigation about the same time. Reform ardor cooled after a few years, and some of the new laws were repealed, but the Armstrong Investigation had a lasting impact on the U. S. life insurance industry.

The difficulty of translating recommendations into action is illustrated by subsequent events in New York. In 1906 Charles Evans Hughes was nominated by the Republican Party for Governor of New York, and was elected. In his Autobiographical Notes he tells of the difficulty he encountered in carrying out his own recommendations:

> But I struck a snag in connection with the Insurance Department. Otto Kelsey had been appointed Superintendent in the preceding May, after the insurance investigation. He was honest but ineffective. Though he had been in office for seven months, and Senator Armstrong and I, in an interview with him shortly after his appointment, had stressed the necessity for making changes, he had utterly failed to clean house. It was plain enough that if the state supervision were not wide awake and competent, we should have despite the new laws, a recurrence of evil practices.[1]

Governor Hughes asked for Kelsey's resignation, but the latter refused. The Governor then asked the Senate to remove him, but a close vote after a bitter fight kept the Superintendent in office. The next year charges were brought against Kelsey, and, after investigation the Governor again

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[1]The Autobiographical Notes of Charles Evans Hughes, ed. David J. Darelski and Joseph S. Tulchin (Cambridge: Harvard University Press, 1973), pp. 136-7.

asked the Senate to remove him, but the decision was the same. Only after Hughes was reelected in 1908 did Kelsey resign.[1]

Temporary National Economic Committee

National attention was drawn to the life insurance industry a second time during the hearings of the Temporary National Economic Committee in 1939 and 1940. President Roosevelt sent a Message to the Congress on April 29, 1938, in which he made several recommendations for strengthening the antitrust laws. Included was this passage about the insurance industry:

> The tremendous investment funds controlled by our great insurance companies have a certain kinship to investment trusts, in that companies invest as trustees the savings of millions of our people. The Securities and Exchange Commission should be authorized to make an investigation of the facts relating to their use as an instrument of economic power.[2]

To implement the President's recommendation, the Congress, on June 16, 1938, passed a resolution,

> Authorizing and directing a select committee to make a full and complete study and investigation with respect to the concentration of economic power in, and financial control over, production and distribution of goods and services.[3]

As requested by the President, the Securities and exchange Commission, through its Chairman, William O. Douglas,

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[1] *Ibid.*, pp. 137-8.

[2] U. S. Congress, Temporary National Economic Committee, Investigation of Concentration of Economic Power. Hearings Before the T.N.E.C., Part 1. "Economic Prologue," 75 Cong., 3d Sess., 1938, p. 190.

[3] *Public Resolution* No. 113, 75th Cong., 2nd Sess., June 16, 1938.

directed the presentation to the Committee of material relating to the life insurance industry. This began on February 6, 1939. (Mr. Douglas was a member of the Temporary National Economic Committee, which was composed of equal numbers from the Executive and Legislative branches of the Federal Government.)

At the beginning of the presentation concerning the life insurance industry, Mr. Douglas called attention to the Armstrong Report, and urged the other Committee members to read it. He pointed out that "similar hearings were begun in other states, and there resulted a general tightening of state regulation of insurance companies."[1] The first specific problem investigated was "insurance company managements and how they are elected. This is a logical point of approach," he said, "since management formulates investment policy."[2]

During the course of the Hearings information was gathered from persons representing all phases of the industry: officers and directors, attorneys, management, agents, consumers and regulatory personnel. When the Final Report was presented to the Senate on March 31, 1941, twelve specific recommendations were made about the life insurance industry.

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[1]U. S., T.N.E.C., op. cit., February 6, 1939, p. 1162.

[2]*Ibid.*, p. 1163.

The first eight of these recommendations called for strengthening of state supervision through more adequate financing and better qualified personnel, in order to improve examination procedure and give closer regulation and supervision of agents and agency practice.

The ninth called for fewer and simpler policy forms, and the tenth urged closer supervision of "competence and activities of company management." The eleventh urged that "The life insurance business should be conducted on a competitive basis, with emphasis on management efficiency rather than sales promotion." The last called for changes in the conduct of industrial insurance (partly because of great losses to consumers through high lapse rates).[1] As mentioned in Chapter II, this form of insurance is of declining importance today.[2]

In addition to the above, which were adopted unanimously, Commissioner Sumner T. Pike of the Securities and Exchange Commission,

> Personally recommended(ed) a liberalization of investment laws to permit life insurance companies to invest a relatively small percentage of their funds in common stocks which would stimulate healthier financial structures and have a wholesome effect on the economy.[3]

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[1]U.S., T.N.E.C., Final Report and Recommendations, March 31, 1941, pp. 41-2.

[2]See p. 50.

[3]*Ibid.* (These recommendations for liberalization of investment laws have largely been accomplished since World War II.)

Commissioner Pike also made a separate statement (concurred in by two other members) in which he called for "a designated Federal Agency" to have certain powers of gathering information and of prohibiting "paying surrender values during a limited period" in times of "serious economic stress." He also called for an Insurance Advisory Council, to advise both Congress and appropriate state agencies, and "to assist the states whenever possible in strengthening their own regulatory activities."[1] This difference of opinion as to the relative merits of state and federal control continues to the present. The next section will discuss the usual elements of state control, and will be followed by a brief consideration of the Federal-State controversy.

State Regulation

Each state determines its own requirements for the organization of an insurance company. It prescribes certain operating procedures for those companies and for foreign

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[1]Ibid., p. 45. The presentation of the Final Report of the T.N.E.C. came at a time when the nation had already begun to organize as the "arsenal of democracy." The concentration of defense contracts in four states and "six clearly interrelated corporate groups" was accentuating the very thing the Committee's study was designed to prevent. (T.N.E.C. Final Report, p. 4.) The initial portion of the Final Report closed with these words: "Our recommendations are intended to enable the individual to maintain himself freely, both economically and politically. They are not intended to extend the power of Government over business or over the individual. The purpose of the committee is to suggest such policies as seem calculated to restrain the continued progress of concentration which so obviously is undermining the foundations of both free enterprise and free government." Ibid., p. 10.

(out-of-state) companies desiring to do business within the State. These requirements are concerned basically with financial integrity (solvency) and with equity, or fairness, in operation.

Under the first category, states set minimum requirements of capital and surplus necessary for the organization of a company. These vary widely, as will be shown in Chapter IV.[1] Reserves are required for protection of policyholders, and acceptable types of investments for those reserves are specified. The usual administrative procedures of required reports and periodic inspections encompass a variety of actions among the states.

The marketing of insurance is regulated by requirements for policy approval and for licensing of agents.[2] Some states have comprehensive regulations pertaining to advertising and business conduct; others devote more attention to policy provisions. According to one well-known text in the field of business regulation, "An effort is made to assure fairness in the settlement of disputed claims, some states seeking to

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[1]p. 134.

[2]In Texas on August 31, 1973, there were 41,575 Group I licenses (legal reserve agents, Art. 21.07-1 Code), and 20,855 Group II licenses (non-legal reserve agents, Art. 21.07) in effect. These figures represent increases of 11 per cent and 7 per cent, respectively, over the number in force at the end of the previous fiscal year. (Texas, State Board of Insurance, Ninety-Eighth Annual Report for the Year Ending August 31, 1973, p. vii).

avoid the time and cost of litigation by providing machinery to arbitrate disputes."[1]

In general, life insurance rates are not controlled by regulation. Texas follows this pattern, however, rates for fire and casualty insurance are not only controlled, but are set by the State Board of Insurance. This is a very time-consuming function.

As might be expected, the quality of state insurance regulation varies considerably. In contrast to some who deplore this fact, Clair Wilcox believes" . . . the policyholder is protected by the fact that his company must meet the standards in every state--and thus in the strictest state--in which it operates." He further believes, "On the whole, state regulation has operated to assure financial soundness and to discourage unfair practices."[2]

Current Status of Federal-State Controversy

The controversy has existed for over a century, and even if a change were made to Federal control--which the writer thinks unlikely--the differences of opinion would not

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[1]Clair Wilcox, Public Policies Toward Business, p. 611. The Oklahoma Insurance Commissioner is very diligent in attention to any claims which policyholders have against the companies, or the Insurance Department, and is widely recognized for this in the State and in the insurance industry. During an interview in Oklahoma City, August 6, 1973, he provided figures for the activity of the Claim Department for 1972, showing: incoming mail-16,798, outgoing mail-22,002, telephone calls-13,915 and personal calls by claimants-1,917, for a total of 54,632 claims.

[2]Clair Wilcox, op. cit., p. 611.

be reconciled. In 1885 Insurance Commissioner Elizur Wright of Massachusetts advocated Federal supervision and regulation:

> Inasmuch as insurance is a general interest, and every insurance institution should be secured as much as possible against the adverse operation of local causes, it is difficult for us to perceive why the supervision of all insurance companies of every sort intended to operate beyond the limit of State lines should not be a function of the general government. There seems to be no less reason for regulating it by a national bureau than for taking the census of encouraging agriculture or invention by one. Simplicity and economy seem to require it.[1]

On the eve of the Armstrong Investigation, Senator John F. Dryden of New Jersey (1902-1907), the founder and President of the Prudential Insurance Company of America, introduced a bill for federal regulation of insurance. Speaking on November 22, 1904, to the Boston Life Underwriters Association, he advocated "The Regulation of Insurance by Congress." He spoke of the time and expense involved in furnishing to "some fifty (*sic*)different supervisory authorities or insurance departments (special information) . . . which, when furnished, is of no practical use either to the state or to the policyholder." He thought ". . . the time has come when it behooves us seriously to consider whether relief cannot be had from Congress . . . substituting federal regulation of the interstate insurance business . . . for the

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[1]<u>Annual Report of Insurance Commissioner, 1865</u>. Quoted in John F. Dryden, <u>Addresses and Papers in Life Insurance and Other Subjects</u> (Newark, New Jersey.: The Prudential Insurance Co. of America, 1909), p. 178.

present method of oversupervision by some fifty different insurance departments."[1]

A more recent expression of a similar position is represented by testimony before the Subcommittee on Antitrust and Monopoly of the Senate Judiciary Committee (Senator Philip Hart, Chairman) in its 1969 hearings. Finance Professor Oscar R. Goodman of Roosevelt University, member of the American Risk and Insurance Association, and economic consultant to the House Banking and Currency Committee, advocated Federal regulation:

> It is time for us to realize and accept the fact that State regulation has failed to regulate the risk of insolvency among insurance carriers. Solvency should be the primary purpose of government regulation, and this basic need is not met by present State regulation.[2]

Similar criticism has been voiced both within and outside the industry. In the summer of 1973 an article by two staff reporters of The Wall Street Journal was entitled, "The States' Regulation of Insurance Companies Often Viewed as Farce."[3] The criticisms in this article are similar to to those expressed by Ralph Nader in testimony before Senator

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[1] Ibid., pp. 175-6.

[2] U. S., Congress, Senate, Committee on the Judiciary, The Life Insurance Industry, Hearings before the Subcommittee on Antitrust and Monopoly, 91st Cong., 1st Sess., 1940, p. 8950.

[3] William Blundell and Priscilla Meyer, "The States' Regulation of Insurance Companies Often Viewed as Farce," The Wall Street Journal, August 21, 1973, pp. 1, 16.

Hart's Committee.[1] Among the criticisms listed are; insufficient beginning capital requirements, inefficient and incompetent examiners--particularly for electronic data processing--anachronistic regulations unable to deal with holding companies, and regulatory agencies which are "creatures" of the industry. The story further states that, "Most often (concerns in serious financial trouble) are quietly bailed out by state regulators who negotiate behind the scenes to forcibly merge them or sell of their policies to well-financed larger companies . . . ."[2] It should be noted that Joe Hunt, the long-time Insurance Commissioner of Oklahoma, has stated that he felt there were many misrepresentations in the story.[3] Clay Cotten, Insurance Commissioner of Texas from 1965 to December, 1974, expressed his criticism of the article in a letter:

> I personally resent this article since it is based upon matters that happened largely a great number of years ago. I did a study for the NAIC (National Association of Insurance Commissioners) that demonstrated that there was less loss to policyholders through state regulation of life insurance than to bank depositors. I was further able to demonstrate that the loss to policyholders was fractional in comparison to the money paid to the FDIC by banks for depositor protection. I am sure you are aware of the fact that in the State of Texas we now have guaranty acts covering substantially all lines of insurance (except title

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[1]p. 12.

[2]Blundell and Meyer, loc. cit., p. 1.

[3]Interview, Oklahoma City, August 6, 1973.

insurance, fraternals, farm insurance and some of the smaller mutual companies). The article was slanted and unfair.[1]

Another recent Wall Street Journal article dealt with the power of insurance lobbies at the State level, and quoted David Greenstone, Chairman of the Department of Political Science, University of Chicago, as follows:

> State legislators typically lack staffs of their own, so they must rely on lobbyists for technical information and guidance. Press coverage of state government isn't as intense as it is in Washington, so lobbyists have more room to operate. Finally, I think history shows that official venality is more prevalent at the state level than in Congress. Given a choice, most industries would opt for state regulation.[2]

It is reasonable to expect that state regulatory officials would favor continuation of the present system. It should be noted that Joe Hunt, the long-time Insurance Commissioner of Oklahoma strongly favors State regulation.

> Ask Oklahoma Insurance Commissioner Joe B. Hunt on any Monday, Wednesday or Friday what his top priority is and you'll get the same answer on Tuesday, Thursday and Saturday: "Keeping the feds from regulating the insurance business and competing with private industry."
>
> "It's a constant battle," said the Commissioner in a recent interview, "to have the answers for those Congressmen who keep trying to make hay by saying they have found weaknesses in the state regulation of the industry."

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[1]Letter to writer, August 21, 1973.

[2]Jonathan Laing and Frederick Klein, "Industry Lobbies are Active and Powerful at the State Level. A Case in Point is Illinois Where Insurance Men Possess Great Leverage," The Wall Street Journal, June 6, 1974, p. 1.

"We have a healthy climate for the industry here in Oklahoma. The companies have done a tremendous job in the economic support they have given this state. In fact, we have more than 1,100 companies licensed to do business with our residents."[1]

Many industry spokesmen could be quoted in favor of State regulation, though some may favor Federal supervision. Their views are based on a variety of reasons, both philosophical and practical. Hunter McLean of Fort Worth, Texas, whose experiences have included both company direction and State Supervision, as Chairman of the State Board, believes the cost element alone is a significant one:

> Pre-emption of insurance regulation by the Federal Government is no answer, would only compound the suppression of ideas and progress. The expenses imposed on life companies by the S.E.C. in connection with the variable life policy is, by comparison, a minor concern. The cost and adequacy of a Federal regulatory agency is the greatest concern . . . .
>
> Nor did the financial disasters of the great depression give comfort to Federal regulation, as documented by the Temporary National Economic Committee, one of the most prestigious and certainly the most acclaimed Committee ever appointed by Congress, in its conclusions that costly failures of National banks reflected adversely upon the quality of Federal bank regulation whereas the modest loss from life company failures demonstrated the high quality of their State regulation.[2]

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[1]Southern Insurance Regional, A Publication of Insurance Information Institute, July 31, 1973, p. 1.

[2]William Hunter McLean, former Chairman, State Board of Insurance, letter to Don J. Willmon, Dallas, October 4, 1973. Mr. McLean also cited the study made by Commissioner Cotten comparing costs of the FDIC with losses from life insurance company failures. "Over a 30-year period, FDIC regulatory costs ranged from a high of $830 per $1 million of all bank deposits annually to a low of $310 per $1 million of all bank deposits annually. Life insurance company failures at that time (1938-1967) cost life policyholders 74¢ per million of reserves annually. That record offers no basis for assumption that Federal regulation of insurance companies would improve upon State regulation for solvency or provide added benefits to policyholders."

Another approach to the problem, and one often overlooked in the partisan discussion, was brought out by Spencer L. Kimball in an address to The Association of Life Insurance Counsel in 1968:

> There is importance to our whole society, altogether transcending and overriding industry interests, of some fundamental political values urging state level regulation. The very basis of our federal system is at issue. Decentralization and dispersion of political power is in itself an important value in a democratic society. Concentrations of power are bad, per se, and it is irrelevant whether the concentrations are in government, in labor, or in business . . . . Finally, I think it can be suggested that uniformity is a much overrated virtue.[1]

The economist qua economist may not be able to take a position on this last point. However, it certainly cannot be ignored. In judging the performance of the industry, various standards will be considered. In Chapter VI some of the conflicting purposes of regulation will be discussed. It will be shown, for example, that restrictions designed to prevent centralization of economic power may be superimposed on regulation of insurance company investments in a way that have nothing to do with the safety of the company's finances. Chapter IV will describe the industry in Texas to prepare the way for the discussion of the Texas regulatory system in Chapter V.

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[1]Spencer L. Kimball, "The Case for State Regulation of Insurance" in Kimball and Denenberg, op cit., p. 416, 421. Mr. Kimball's strong feeling on this point of centralization of power may be partially explained by his background. A Phi Beta Kappa graduate of the University of Arizona, he attended Oxford University as a Rhodes Scholar and received a Bachelor of Civil Laws degree. After teaching in the Law School of the University of Utah, he was appointed Dean of the University of Wisconsin Law School in 1968. (Foreword to Kimball and Denenberg, op. cit., p. x.)

CHAPTER IV

THE LIFE INSURANCE INDUSTRY IN TEXAS

The life insurance industry of Texas began during the days of the Republic, and was continued during the early days of Statehood in a similar manner. The initial efforts were designed to meet frontier conditions, and so the industry grew in a way quite different from the companies which served primarily large population centers. This chapter will describe the modern industry which developed from that frontier beginning, and will indicate how Texas companies and their policies differ from the companies and the policies of other states. The chapter will discuss the differing problems of small and large companies, and will end with an examination of the economic and political climate for insurance in Texas.

Early History

In 1972 Texas had more legal reserve life insurance companies (219) than any state except Arizona (388). The state in third place, Louisiana, had less than half as many (99).[1] If all types of non-legal reserve life companies are

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[1] *Life Insurance Fact Book 1973*, p. 90.

included, the figure is much larger--723 as of August 31, 1973.[1] This is a reduction of 30 per cent from the number of companies in the early and middle 1950s.[2]

Many of these companies were created to serve an economy which was largely rural and agricultural, with great distances between population centers. Under these conditions an insurance agent found his prospects widely separated. The situation is colorfully described by Hunter McLean, speaking at the Twenty-fifth Anniversary of the Texas Legal Reserve Officials Association, when he said:

> It was in those decades that Texas law, responsive to this isolation, authorized several types of aid societies or associations to permit the few hundred souls surrounding a hamlet to band together to care for each other in the event of death or disability . . . .
>
> These conditions gave rise to a very large number of small insurance companies in Texas that have been the subject of so much misunderstanding elsewhere in the nation, and sometimes in recent years in Texas. The number of life and disability assessment associations in Texas grew until in the late 1930's they totalled some 1,100. Many were managed by farmers or ranchers. A large number were managed by undertakers, a "conflict of interest" and form of "insider trading" which in other corporations would send the SEC into orbit.
>
> As the insureds grew older, and the assessments for death or disability became more frequent and costly, younger insureds looked elsewhere, and found legal reserve life insurance more suited to their pocketbooks. That, coupled with inexpert management, brought hundreds of associations to their knees.

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[1]Texas, State Board of Insurance, Ninety-eighth Annual Report for the year ending August 31, 1973, p. 7.

[2]Texas Legislative Council, Insolvency in the Texas Insurance Industry, 1939-1954 (Staff Research Report #53-5), December, 1954, p. 9.

> Their failures or mergers, though most were tiny in numbers of insureds, provided the statistical base of companies retired in Texas which, in turn, led to adverse publicity in the state and in the nation all out of proportion to the facts.[1]

Mr. McLean also outlined the changes through the 1920s and 1930s when local mutual aid and fraternal benefit associations were placed under increasing State regulation. He stated that, "Many of Texas' finest companies today had origins as assessment associations, converted to limited capital stock companies, then converted to full capital stock companies." In answering criticism of a regulatory system which allowed so many companies to go out of business by merger or reinsurance, he stated, ". . . it was <u>because</u> of strong laws, not for the lack of them, that the companies were retired from business."[2]

In considering more recent growth, both in number of companies and amount of insurance sold, Don Dunham, Deputy Assistant Administrator of the Texas State Board of Insurance, compared the growth in insurance with the growth in population. He stated that the two prime growth areas for insurance since World War II have been around Atlanta and in Texas. The oil and gas industries, petro-chemical industry, electronic industries and NASA have created extensive new markets in

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[1]William Hunter McLean, First President of Texas Legal Reserve Officials Association and former Chairman, State Board of Insurance. Speech, Houston, August 17, 1973, p. 2.

[2]<u>Ibid</u>., pp. 3-4.

Texas. "You have the growth where there is a need," stated Mr. Dunham.[1]

This same growth pattern has existed throughout the South and Southwest, and undoubtedly has something to do with the large number of companies in Arizona. The growth in New Mexico from increased governmental activity has been accompanied by a marked increase in insurance in that State.[2]

Number and Size of Companies

This study is primarily concerned with legal reserve companies, as they write the vast majority of life insurance today. A simplified definition of such a company is given in the *Life Insurance Fact Book*: "A life insurance company operating under State laws specifying the minimum basis for the reserves the company must maintain on its policies."[3] An insurance textbook gives a more complete definition and explanation:

> Life insurance premiums as such are not generally subject to regulation by the various state regulatory authorities. The adequacy of such premiums is regulated indirectly by regulation of reserve liabilities. Because of the regulation of policy reserves, they have come to be known as legal reserves and the term "legal reserve life insurance company" has come to be commonly applied to companies carrying such reserve liabilities in their financial statements. Actually, the states only prescribe the

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[1] Interview, Austin, October 23, 1973.

[2] *Ibid*.

[3] *Life Insurance Fact Book 1973*, p. 121.

> basis on which minimum reserves are to be calculated, the companies being permitted to use any other basis which results in reserves equal to or greater than those produced by the statutory method. The basis is stated in terms of the mortality table to be used, the maximum rate of interest to be assumed, and the valuation method to be applied.[1]

The Life Insurance Fact Book and Best's Insurance Reports, Life/Health include information on legal reserve companies only. The State Board of Insurance issues annually a List of Insurance Companies Authorized to Transact Business in Texas. This includes all types of insurance companies, both domestic and foreign. The list shows the total amount of insurance in force for each of the life insurance companies, as well as the address of the company and principal officers. The Texas Blue Book of Life Insurance Statistics[2] is commercially published, and contains financial and operating statistics for a three-year period for all life insurance companies authorized to do business in the State. The Annual Report of the State Board of Insurance reports the number of companies in operation, with names of all new companies, and companies which had any change in status during the year. It also includes detailed information about the operations of all the sections of the State Board. The information in Table IV-1 is taken from the Ninety-Eighth Annual Report for the year ending August 31, 1973.

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[1]Huebner and Black, op. cit., pp. 374-5.

[2]The Texas Blue Book of Life Insurance Statistics, 30th Annual Edition, 1973 (Dallas: The Record Publishing Co., 1973).

TABLE IV-1

LIFE INSURANCE COMPANIES LICENSED IN TEXAS
AUGUST 31, 1973

Type of Company	Texas	Foreign	Total
Stock Life Insurance Companies	212	371	583
Mutual Life Insurance Companies	10	65	75
Stipulated Premium Life Insurance Companies[1]	57		57
Non-Profit Life Insurance Companies[2]		1	1
Fraternal Benefit Societies[3]	12	27	37
Total	291	464	755
Statewide Mutual Assessment Life, Health and Accident Insurance Companies[4]	8		8
Local Mutual Aid Associations[5]	150		150
Burial Associations[6]	79		79
Exempt Associations[7]	21	___	21
Total	258		258
Grand Total	549	464	1,013

Source: State Board of Insurance, Ninety Eighth Annual Report for the year ending August 31, 1973.

[1]A refinement of a burial association or mutual assessment company. It must maintain such reserves as are determined by the State Board of Insurance, and may adjust its premiums if necessary to do so. (Texas Insurance Code 1969, Chap. 22.)

[2]This company is Group Hospital Service Inc. (Letter, Creg Hargis, Clerk, Committee in Insurance, House of Representatives, July 22, 1974.)

[3]A Society with a lodge system and representative form of government, or a secret fraternity with a lodge system and representative form of government may make provision for insurance benefits. (Code, Chap. 10, Art. 10.01)

[4]Only such companies as were incorporated under preexisting law, and were actually operating prior to January 1, 1933, are authorized. (Code, Chap. 13, Art. 13.01.)

[5]Many of these are operated by funeral homes. Their operations must be confined to a single county. (Code, Chap. 12.)

[6]A Burial Association must operate under the laws pertaining to a Local Mutual Aid Association (Code, Chapt. 12.), but may make payments partly or wholly in merchandise of services, not in excess of $150. (Code, Chap. 14, Art. 14.37.)

[7]"According to the State Insurance Board, the 'Exempt Associations' are fraternal operations." Letter, Creg Hargis Clerk, Committee on Insurance, House of Representatives, July 22, 1974.

The total of all Texas companies and associations is 549. This number is 85 more than the total of foreign companies operating in the State.[1] By way of contrast, the State of Oklahoma has 54 legal reserve life insurance companies. This number is a tie with California for eighth place among the states in number of companies.[2] The total of all types of life insurance companies, both domestic and foreign, licensed to do business in Oklahoma is 1,126.[3] Mr. Hunt, State Insurance Commissioner, stated that there are more out-of-state companies licensed in Oklahoma than in 47 other states.[4] The President of Western National Life of Amarillo, E. Jay O'Keefe, stated, "A company appreciates Joe Hunt." He said his company had no difficulty getting licensed in Oklahoma, whereas in some states the time involved was as long as three years. Querried as to whether this was due to inefficiency or to give an opportunity for some form of "pay off," he said it could be either, but that Western National would not pay any form of bribery.[5]

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[1]The term "foreign" is used to denote companies domiciled in other states, and "alien" for companies domiciled in other countries. The Canadian companies are often included with the U. S. companies, however.

[2]Life Insurance Fact Book 1973, p. 90.

[3]Oklahoma, State Insurance Commissioner, Sixty-sixth Annual Report and Directory, 1973, p. 6.

[4]Interview, Oklahoma City, August 6, 1973.

[5]Interview, Amarillo, Texas, December 20, 1973.

In Chapter II the total assets and insurance in force for the fifty largest Texas companies were shown. These companies are listed in Table IV-2 with year of organization, initial capital structure, and premium and annuity income for 1973.

Only two of these fifty companies are mutuals, whereas the five largest companies in the nation, and twenty-six of the top fifty are mutual companies. One other of the top fifty was organized as a mutual--Republic National, number four in terms of assets, and second in insurance in force.[1] One of the Texas mutuals, Praetorian, began as a fraternal organization, as have others which are not in the top fifty.

Many of the Texas companies have grown by merger and combination, whereas the largest companies in the nation have expanded through internal growth. Albert W. Atwood, writing in 1945 (primarily about the Mutual Benefit Life Insurance Company of Newark, N. J.) called attention to this characteristic:

> In numerous lines of industry the larger units have become great and all-powerful through combinations, mergers, and the absorption of smaller competitors. This is in no sense the case in life insurance. The Mutual Benefit has never merged with any other company; it has not even grown by reinsurance. As a matter of

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[1]As mentioned in Chapter I, one of the continuing controversies in the life insurance field concerns the relative merits of mutual and stock companies. A strong argument for mutualization of all companies is found in Halsey D. Josephson, Life Insurance and the Public Interest (New York: Crown Publishers, Inc., 1970).

TABLE IV-2

FIFTY LARGEST TEXAS LIFE COMPANIES
Year of Organization, Initial Capital Structure, Premium and Annuity Income, 1973

Company and Year Organized	Initial Capital	Initial Surplus	Premium & Annuity Income
American National (1905)	$100,000	$ 20,000	216,137,892
Southwestern Life (1903)	100,000	100,000	148,424,249
Southland Life (1908)	300,000(1917)	not given	95,298,961
Republic National (1928)	(mutual)		
converted to stock co. (1930)	100,000	100,000	284,359,442
Great Southern (1909)	119,690	84,254	402,314,551
American General (1925)	250,000	125,000	52,837,545
Fidelity Union (1927)	100,000	100,000	61,794,066
Variable Annuity (1955)	100,000	92,986	63,839,367
Reserve Life (1938)	25,000	not given	90,166,364
Tennessee Life (1955)	100,000	100,000	62,214,005
U.S. Life (1968) (formerly Great National)	100,000	200,000	1,353,168
United Fidelity (1920)	500,000	250,000	15,731,416
Great American Reserve (1937)	25,000	30,837 (after 3 yrs.)	29,223,909
Government Personnel Mutual (1934)	(mutual)		13,889,141
Great Commonwealth (1955)	25,000	12,500	10,205,943
World Service Life (1947)	25,000	12,500	27,311,129
Union Bankers (1953)	422,158	(incl. surplus)	28,268,611
American Founders (1954)	250,000	(incl. surplus)	12,743,727
Southwestern General (1968)	1,000,000	500,000	16,871,824
(took over Universal Life & Accident, formed 1927)	(50,000)	(50,000)	
Transport Life (1958)	250,000	250,000	25,507,850
Pioneer American (1946)	100,000	500,000	7,185,037
Texas Life (1901)	100,000	not given	5,231,041
Group Life and Health (1952)	25,000	12,500	68,051,861
Western National (1944)	35,000	35,000	16,284,268
USAA Life (1963)	1,000,000	1,000,000	10,513,797
American Security (1935)	25,000	not given	14,491,159
United American (1947)	25,000	not given	19,146,360
Praetorian Mutual (1899)	(Fraternal Insurance Society)		
converted to mutual company (1958)	(mutual)		3,261,859
Life of the Southwest (1955)	25,000	12,500	20,351,275

TABLE IV-2, continued

	Initial Capital	Initial Surplus	Premium & Annuity Income
Gulf Atlantic (1962)	500,000	1,000,000	13,340,613
State Reserve (1924)	100,000	100,000	4,148,546
Combined American (1944)	25,000	not given	12,323,140
Lone Star Life (1951)	100,000	5,000	13,760,736
National Farm Life (1946)	25,000	10,000	2,606,971
Gibraltar Life (1946)	250,000	50,000	2,423,460
Great Southwest (1951)	(not given)		3,533,434
United Liberty (1953)	100,000	50,000	7,411,466
First Continental (1954)	50,000	50,000	8,856,533
American Capital (1954)	25,000	12,500	3,265,613
Continental Life (1969)	103,000	103,000	1,342,371
Peerless Life (1955)	(not given)		1,433,721
American Bankers (1946)	25,000	12,500	3,967,593
Eureka Life of America (1953)	25,000	12,500	3,686,845
Coaches of America (1965)	890,000	(including surp.)	8,479,963
Citizens Standard (1953)	40,000	20,000	2,441,670
North America (1948)	30,000	15,000	2,316,668
Employers National (1961)	200,000	800,000	3,868,669
Industrial Life (1945)	25,000	25,000	6,206,702
Republic-Vanguard (1965)	500,000	500,000	2,043,844
United National (1954)	25,000	12,500	1,477,333

Source: List of Companies from Texas Parade, July, 1974.
Year of organization, capital and surplus data from Best's Insurance Reports, Life/Health, 1973
Premium and Annuity Income from Letter, Chairman, State Board of Insurance, August 1, 1974

> fact, neither the Metropolitan, the largest of the companies, nor any of the other of the largest, has attained its present size primarily through the merger of absorption of other companies. Nor does the practice of interlocking directorates prevail among life insurance companies.[1]

Of the ten largest companies in the nation (ranked by assets), only one has acquired another life insurance company. In 1969 John Hancock acquired Maritime Life Assurance of Halifax, Nova Scotia--hardly significant in relation to its size. By contrast, of the top ten Texas companies, all but two have acquired, by merger or reinsurance, the insurance of other companies. One of these (Tennessee Life) is a wholly-owned subsidiary of Philadelphia Life Insurance Company. Republic National has acquired seven other companies, and Reserve Life (mostly by reinsurance), has acquired the business of eleven other companies.[2]

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[1]Albert W. Atwood, The Great Stewardship. A Story of Life Insurance (New York: Harper & Bros., 1945), p. 156-7. A random check of 100 names in Who's Who In Life Insurance (Englewood, N. J.: The Underwriter Publishing Co., 1974) tends to confirm this last item. The book lists officers, and not those who serve only as directors. There were very few shown as officers or directors of more than one company. Most of the multiple affiliations seemed to be (from the similarity of names) with related companies, such as Great American Reserve Insurance Company, and Great American of Dallas Fire and Casualty Company.

The practice of interlocking directorates with other types of financial institutions is not at all uncommon, however. It began in the post-Civil War years, as brought out in this statement from a well-known text in economic history. "The more successful investment banks soon discovered that control of commercial banks, trust companies, and insurance companies would greatly increase their power and influence." (Gilbert C. Fite and Jim E. Reese, Economic History of the United States, 3rd ed. (Boston: Houghton-Mifflin, 1973), p. 307.)

[2]Best's Insurance Reports, Life/Health, 1973

In recent years several of the leading national companies have acquired--or organized--fire and casualty companies, mutual fund operations and other types of financial service organizations. These are the result of growth, rather than its cause.

The following Tables, IV-3 and IV-4, with information from the Ninety-Eighth Annual Report of the State Board of Insurance, show changes in companies operating in Texas during the last fiscal year.

TABLE IV-3

NEW COMPANIES ORGANIZED OR ADMITTED TO TEXAS, SEPTEMBER 1, 1972-AUGUST 31, 1973

Type of Company	Texas	Foreign	Total
Stipulated Premium Insurance Co.	7		7
Stock Life Insurance Companies	7	28	35
Exempt Associations	1		1
Totals	15	28	43

The Annual Report further showed 28 Texas Life Insurance companies in Receivership on August 31, 1973, ten in Conservatorship and two under Supervision.[1] (Actions under these conditions will be described in Chapter V.)

A comparison of the amount of business by Texas and foreign life insurance companies is taken from the "Summary of Information From Annual Statements."

[1]Ninety-eighth Annual Report, pp. 22-28.

TABLE IV-4

NEW COMPANIES ORGANIZED OR ADMITTED TO TEXAS
Between September 1, 1972, and August 31, 1973

Texas Companies	Reinsured or Merged	Dissolved or Withdrawn	Permanent Receivership	Total
Stipulated Premium Insurance Cos.	1	1		2
Stock Life Insurance Cos.	7	2	1	10
Local Mutual Aid Associations	5	1		6
Local Mutual Burial Associations	1			1
Exempt Associations		1		1
Statewide Mutual Assessment Cos.	2			2
	16	5	1	22
Foreign Companies				
Stock Life Insurance Companies	2			2
Totals	18	5	1	24

Source for both above tables: State Board of Insurance, Ninety-eighth Annual Report, p. 14.

The figures in Table IV-5 confirm the overriding importance of legal reserve life insurance in Texas (98 per cent of the total), and further show that Texans have about twice as much life insurance with companies in other states as they have with domestic companies. Figures are not available to show how much was purchased in other states. The influx of population to Texas in the last quarter-century would indicate a substantial amount of the latter. The total premiums and annuity considerations collected by Texas companies (on Texas business)

TABLE IV-5

LIFE INSURANCE IN FORCE IN TEXAS, BY TYPE OF POLICY, BY TYPE OF COMPANY, DECEMBER 31, 1972
(000,000 omitted)

Type of Company	Ordinary	Group	Industrial	Total
Legal Reserve				
Texas Companies	$17,654	$10,016	$ 439	$28,109
Foreign Companies	29,795	25,428	1,541	56,765
Total	$57,449	$35,444	$1,980	$84,874
Other Types of Companies				
Stipulated Premium Companies				232
Fraternal Benefit Societies				
Texas Societies				302
Foreign Socities				815
Statewide Mutual Assessment Companies				42
Local Mutual Aid Associations				215
Burial Associations				21
Exempt Associations (figures not reported as insurance in force)				
Grand Total of Life Insurance in Force in Texas				$86,502

Source: State Board of Insurance, Ninety Eighth Annual Report, pp. 31-38.

for 1972 was $590,422,526, and the comparable figure for foreign companies was $846,405,536.[1] Apparently Texas companies are "gaining" on their out-of-state competitors. These figures indicate that the new business purchased from Texas companies in 1972 was considerably more than fifty per cent of that purchased from foreign companies--the relationship for total business in force.[2]

[1] Annual Report, p. 31

[2] This changing pattern is apparently part of a nationwide trend. According to William Hunter McLean, "Fifty years ago about 90 per cent of the life insurance in the nation was being written in companies domiciled in New York or New England. Now those companies are writing about half of the new insurance." Letter, to Don J. Willmon, June 14, 1972.

Characteristics of Texas Companies and Policies

The most obvious characteristic of Texas life insurance companies since World War II has been the increase in numbers. The large number of returning service men, and the influx of population created the demand; the low entry requirements for a limited capital stock company facilitated the supply. From 1948 to mid-1952, 150 new legal reserve companies were organized in Texas. The state with the next largest number was Louisiana, with seventy-seven. Among the other states, only Illinois and South Carolina had as many as twenty-five.[1] At the end of 1953, Texas had 245 legal reserve companies and 773 fraternal and assessment associations.[2] This latter figure represented one-half the total number of such companies in the nation, and the former figure twenty-eight per cent of the total.

The 1953 figures are considerably larger than the 1972 figures reported above. Although the pace of growth in number of companies has slowed since the mid-fifties, it has not stopped. But larger numbers of companies have been retired; some through receivership, but more through merger and consolidation.

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[1] Life Insurance Fact Book, 1973, p. 41.

[2] Best's Life Insurance Reports, quoted in Staff Research Report, "Insolvency in the Texas Insurance Industry, 1939-1954." (Austin: Texas Legislative Council, 1954), p. 9.

Why and how did this growth come about? The first part of the question can be answered in several ways. The growth of population, as already mentioned, provided an increased demand for the product. The low entry requirements made it relatively easy to organize a new company. Prior to 1958, the operating income of life insurance companies was exempt from federal income taxes, with only the "free investment income" subject to taxation.[1] This provision made a life insurance company an attractive financial device for the accumulation of capital.

The tax advantages, coupled with the low entry barriers, attracted some "promoters" who were not interested in building a company, but in selling stock. The great appreciation in stock values that had taken place in a few selected companies was used to illustrate the profit possibilities for potential investors.

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[1]Huebner and Black, op. cit., p. 754n. "The Life Insurance Company Tax Act of 1959 (Internal Revenue Code, Secs. 801-820). . . represents a so-called 'total-income' approach which involves not only the investment income, but also the gain from operations and the capital gains income. The 1959 Tax Act made life companies taxable on all their income at full corporate rates." *Ibid.*, p. 755.

A further explanation is given by former Texas Board Chairman Hunter McLean: "The income tax law does *defer* taxes on *some* of the earnings of life companies in recognition of the long-term contracts issued by life companies and the possible need for reserves to off-set adverse mortality or asset valuation decline . . . . However, these differences from the general corporation tax are not 'advantages' to either stockholders or policyholders. If the amounts upon which taxes are deferred are not used to repair adversity, they are taxed." Letter, William Hunter McLean, Fort Worth, August 8, 1974.

In many cases the initial stock was sold by the organizers at little or no expense to the company--if the desire was to build a successful company. Sometimes, however, the selling expense was substantial, as in the case of the Union Bankers Life Insurance Company:

> The company, incorporated under the laws of Texas, February 2, 1953, licensed April 6, 1953, and began business July 16, 1953. Initial funds were provided through the sale of 50,000 shares of Series A no par value shares at $0.50 each and 50,000 shares of Series B no par value shares at $10 each, which produced capital and surplus of $422,158 after payment of sales commission of 25 per cent. The Series A shares were purchased by the management and the Series B shares were offered to the public and special contract holders of National Bankers Life Insurance Company, Dallas, Texas.[1]

One of the leading companies of Texas is Great American Reserve Insurance Company, which is now owned by the J. C. Penney Company. It secured surplus by selling stock to the public at a higher price than paid by the organizers:

> Original capital of $25,000 was sold at par, $10 per share, to Travis T. Wallace and C. O. Hambleton who, in turn passed over 49 per cent of the stock (1,125 shares) to trustees for sale at $30 per share, which resulted in net surplus contribution to the company of $30,837 over the years 1937 to 1940, inclusive.[2]

In each of these cases the organizers of the company were in a position to make substantial profits on their original stock when the higher selling price became established. The subsequent success of these companies justified the higher

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[1] Best's Insurance Reports - Life/Health, 1973.

[2] Ibid.

prices, but not all companies were successful. An article in the Chicago Tribune in the early 1960s describes what happened in some cases:

> When the first "public issue" runs out, a second one is floated at a higher price, then a third at a still higher price if the market will bear it, and so on.
>
> After a few such flotations, each at a higher price than its predecessor, a secondary market is likely to develop that is sufficiently strong to enable the "founders," if they wish, to unload their original stock at a profit of several hundred per cent.
>
> At this stage the initial promoter or team of promoters, who of course are among the holders of founders' stock, may do just that and pull out of the organization to go elsewhere and do likewise.
>
> When they do, they leave behind no broken laws, but a lot of publicly held stock in an insurance company, which tho actually operating, has yet to earn--or demonstrate that it could ever earn--the accolades bestowed upon it in the course of the stock promotion . . . .[1]

Some of the newly-organized companies offered their stock for sale in connection with their policies. In order to sell the policy, some special feature was added to make it more appealing--thus a specialty, or "gimmick" policy.[2] A part of the growth of Texas companies came from such a process, but certainly not all of it. Much of the criticism which arose during the 1950s concerned inexperienced agents who used a "canned" talk to sell such policies. Experienced

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[1]Quoted in Spencer L. Kimball and Jon S. Hanson, "The Regulation on Specialty Policies in Life Insurance," 62 Michigan Law Review (1963): 174.

[2]See p. 129-131 for an explanation of such policies.

agents generally could not be hired away from established companies, so new agents were given information about a few specialty policies, but often they had little real knowledge of life insurance. A type of appeal frequently used alledged that " . . . rather then spend money on advertising, the company is creating a special block of policies with particularly attractive features to get some business on the books in a hurry." The prospect was led to believe that the company recommended would be as successful as the examples given.[1]

Whether used in connection with stock sales or not, specialty policies are highly controversial. Spencer L. Kimball[2] and Joseph M. Belth[3] have written about them, as have many others. The Commissioner of Insurance in Colorado, J. Richard Barnes, C.L.U., served as an agent for New York Life before being appointed to his position in 1964, and has seen the problems which such policies can cause:

> In a desperate effort to compete, too many companies try to come out with extremely unusual policies which may not be profitable for them, extremely high commission rates to induce agents to represent the smaller company which finds it harder to sell its product, and increasing costs attendant to rapid growth.[4]

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[1]These statements are based on the writer's knowledge from having heard such presentations.

[2]Kimball and Hanson, loc. cit., p. 174.

[3]Joseph M. Belth, The Retail Price Structure in American Life Insurance (Bloomington: Bureau of Business Research, Graduate School of Business, Indiana University, 1966), Chapter 13.

[4]J. Richard Barnes, Commissioner of Insurance of Colorado, Letter to writer, July 11, 1974.

In an industry with a high degree of product differentiation, however, the specialty policy is an effective means of non-price competition. An excellent technical analysis of such a policy is given by E. Jay O'Keefe, who served as his company's actuary before becoming president. His article was designed to assist agents not selling specialty policies to understand them and meet the competition they posed.

> . . . a specialty policy is defined as one which combined several insurance and other benefit provisions, so that the insured gets under one contract what he might have gotten by purchasing several conventional policies . . . .
>
> It should be clearly understood that this article does not intend to accuse nor imply that any company which sells specialty policies is a bad company or involved in illegal practices, nor to imply that the policies are illegal or actuarilly unsound. . . .
>
> This article will seek to show the objectional features of specialty policies, and to conclude that generally speaking they do not meet the needs of the average insurance buyer . . . .[1]

Mr. O'Keefe gives instructions for calculating the premium for each of the death benefits, and then advises the agents,

> The remainder represents the annual "overcharge" out of which the company expects to pay coupons, dividends and any other living benefits exclusive of the standard non-forfeiture benefits provided by the policy.[2]

Specialty policies have strong defenders and vigorous critics. Kimball and Hanson describe their use:

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[1]E. J. O'Keefe, "Understanding Specialty Policies," Life Association News, June, 1968, pp. 89-91.

[2]Ibid., p. 90.

> First, many of the policies supplement orthodox insurance protection with investment features and other attractions in order to provide a maximum marketing appeal despite admittedly high costs. Second, various orthodox insurance coverages are combined in such a way that benefits vary greatly, and cost comparisons with the traditional policies becomes impossible. In either of these two ways, the specialty company may shift the competition from price to another basis.[1]

Often the specialty policy takes the form of a "coupon" policy. The coupons generally mature annually, beginning when the second annual premium is paid. They may be designed to resemble interest coupons on bonds, or they may take some other distinctive appearance. There are many types of coupon provisions, but most commonly they provide four options: 1) payment in cash, 2) reduction in premium, 3) paid-up additions to coverage or 4) retention to accumulate with interest.

The proponents of all types of specialty policies look on them as a legitimate means of competition--particularly for new and small companies. This view is forcefully expressed in "Editorial Comment" in The National Underwriter:

> It is a well known fact that for some years the proponents of life insurance monopolism have been attacking "special policies" because these plans are superior to the ones they offer. The intent is clear. They want to eliminate the competition these "special policies" give them. It is a well known fact that benefit for benefit the Eastern Monster Companies cannot compete with the superior "special policies" being offered by many smaller non-New York companies. Rather than adopting the American free enterprise method of creating

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[1]Kimball and Hanson, loc. cit., p. 173.

> better policies of their own to compete with the special benefit plans, they seek to deny the American public the opportunity to purchase such plans.[1]

If special policies provide high-cost insurance, some conflict arises in characterizing them as "superior." Professor Belth described his efforts to make an accurate comparison of the costs of such policies, and confessed they were not very fruitful. He was able to secure data from very few companies issuing such policies.

> The results of the study may be summarized by stating that the specialty policies for which sufficient data were obtained may certainly be classified as high-priced policies, since their prices are substantially in excess of the corresponding figures for the low- and medium-priced conventional policies (previously analyzed). At the same time, it must be emphasized that some of the specialty policies studied are lower in price than some of the high-priced conventional policies. In this latter sense, the study suggests that, if specialty policies are to be labelled as excessive in price, it may be necessary to attach a similar label to some conventional policies . . . .[2]

If the price is not excessive, what is the principal objection to such policies? It is ease of misrepresentation and the lack of disclosure of the portion of the price which pertains to the coupon or other specialty. Kimball and Johnson acknowledge there is no inherent vice in a coupon policy, ". . . provided only that it is not put into the hands of people who need something else."[3]

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[1]Quoted in Joseph M. Belth, The Retail Price Structure in American Life Insurance (Bloomington: Bureau of Business Research, Graduate School of Business, Indiana University, 1966), p. 172.

[2]Ibid., p. 179.

[3]Loc., cit., p. 187.

Many students of insurance, even proponents of specialty policies, acknowledge that such policies are subject to misunderstanding and misrepresentation. The complicated nature of the insurance contract, and the lack of understanding on the part of consumers, have already been mentioned. If, in addition, there is a deliberate attempt to mislead, the buyer of insurance is at a great disadvantage.

The present Texas Insurance Code provides that all policy forms must be submitted to the State Board for approval.[1] This is a relatively recent requirement. The Texas Legislative Council, in A Report to the Fifty-fifth Legislature in 1956 stated:

> The most serious problem in the field of legal reserve life insurance in Texas today is that of various types of policy contracts which are devised and promoted by some of the legal reserve companies operating in Texas. For example, the Board of Insurance Commissioners does not have express authority to approve or disapprove contracts of legal reserve insurance which are sold in Texas . . . .
>
> There are certain types of life insurance policies aggressively marketed in Texas today which are contrary to the public interest and which are contrived to lend themselves to fraud and misunderstanding. This problem may be approached in one of two ways: either by requiring approval of all policies by the Board or by specific prohibitions against certain types of policies.[2]

In 1957 the Legislature provided for review of all policies before they were used. According to a 1958 study by the Texas Research League, this was ". . . to prevent the

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[1]Code, Art. 3.42.

[2]Texas Legislative Council, A Review of the Adequacy of Insurance Legislation Enacted by the Fifty-fourth Legislature. A Report to the Fifty-fifth Legislature, December, 1956, p. 68.

use of provisions which might be unfair, unjust, inequitable, misleading, deceptive, or otherwise contrary to law or the public policy of the State."[1]

Such review is now an accepted part of regulation, but, as with many new regulatory requirements, was not well received at first. The 1958 Texas Research League study reported:

> Life policy approval under new statutory provisions has not been a popular regulatory program. The statutes, however, require policies to be reviewed. The controls imposed do not appear to be so rigid as to preclude experimentation with new coverages. They do provide ample authority to prevent the sale of misleading or other improper forms.[2]

At the time of that Report, the Insurance Department was receiving each week an average of 200 new policy forms, and 30 to 60 resubmissions of rejected forms.[3] If innovativeness is to be judged by the number of proposed policy forms, the companies operating in Texas will rank quite high, for the number of forms submitted for approval is now even higher. In the week ending May 24, 1974, a total of 369 forms were submitted to the Policy Approval Section:

85 individual accident and health policy forms
40 credit life forms
68 group accident and health
20 group life forms
10 combination group life and accident and health forms
156 individual life forms[4]

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[1] Regulation of Insurance in Texas; The Job to be Done, the Needs to be Met, (Austin: Texas Research League, December 1, 1958), p. 34.

[2] Ibid., p. 35.

[3] Ibid., p. 34.

[4] Letter, June 5, 1974, Joe Christie, Chairman State Board of Insurance.

Some states have taken more restrictive steps than policy approval for certain types of policies. Kimball and Hanson state that coupon policies were prohibited in Minnesota as early as 1913, and have subsequently been banned in other states.[1] Such action clearly indicates that Texas is not the only state to be confronted with specialty policies of various kinds. But the combination of factors present in Texas in the 1940s and 1950s created the environment in which they were more widely used than ever before. The writer does not mean to imply that such policies were the only means of growth of Texas companies, but to indicate they were used more extensively in this State than in many others.[2] Much growth came through the sale of conventional policies.

Initial Capital Requirements

Much criticism has been directed at Texas in the past--and some in the present--for the alleged inadequacy of initial capital and surplus requirements. According to a study by the Texas Legislative Council, the first body of uniform laws governing the chartering of stock life insurance companies was enacted in 1874, and required initial, fully paid capital of $100,000.[3] This requirement remained until 1955, when an additional $100,000 surplus was required. In 1909, however, provision was made for "Limited Capital Stock" life insurance

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[1]Loc. cit., p. 198.

[2]Don J. Willmon, Interview, Amarillo, October 27, 1973.

[3]Gammel's Laws, pp. 199-202. Quoted in Texas Legislative Council, op. cit., p. 12-13.

companies, with initial requirements of only $25,00 capital. Such companies were allowed until 1955. Although none could could be formed after that time, existing companies could continue under a "grandfather clause."[1]

The 1956 Report by the Texas Legislative Council states that the members of the Board of Insurance Commissioners (predecessor of the State Board of Insurance) were in general agreement that the new requirements ($100,000 capital and $100,000 surplus) were adequate.[2]

Texas still ranks among the three states with the lowest requirements in this area, however, as Table IV-6 shows:

TABLE IV-6

INITIAL CAPITAL AND SURPLUS REQUIREMENTS
FOR STOCK LIFE INSURANCE COMPANIES
AND NUMBER OF LEGAL RESERVE COMPANIES,
BY STATE, 1972

State	Capital ($000)	Surplus ($000)	Combined ($000)	Number of Legal Reserve Companies
Alabama	400	600/400	1,000/800	52
Alaska	200	100	300	2
Arizona	100	50	150	388
Arkansas	250	250/125	500/375	27
California	450	250/225	900/675	54
Colorado	200	100	300	30
Connecticut	(no minimum requirement)			
Delaware	300	150	450	29
District of Col.	200	100	300	10
Florida	500	750/100	1,250/600	28
Georgia	200	200	400	30

[1] Code, 1969, Art. 3.02, Sec. 2.

[2] Texas Legislative Council, Report, op. cit., pp. 12-13.

TABLE IV-6 continued

	Capital ($000)	Surplus ($000)	Combined ($000)	Number of Legal Res. Cos. (1972)
Hawaii	200	100	300	9
Idaho	400	400	800	5
Illinois	750	500/300	1,250/1,050	93
Indiana	400	600/50	1,000/450	55
Iowa	350	400	750	27
Kansas	300	300	600	22
Kentucky	500	750	1,250	18
Louisiana	100	200	300	99
Maine	1,000	1,000	2,000	4
Maryland	500	750/500	1,250/1,000	16
Massachusetts	400	800	1,200	17
Michigan	1,000	500	1,500	18
Minnesota	450	225	675	24
Mississippi	200	300/150	500/350	16
Missouri	200	200/100	400/300	42
Montana	100	100/50	200/150	4
Nebraska	200	200	400	31
Nevada	200	500/100	700/300	2
New Hampshire	600	400	1,000	3
New Jersey	200	100	300	15
New Mexico	100	200	300	5
New York	1,000	2,000	3,000	62
North Carolina	200	200/50	400/250	22
North Dakota	150	75	225	11
Ohio	500	600	1,000	43
Oklahoma	250	125	375	54
Oregon	Flexible	Flexible	500	8
Pennsylvania	1,000	500	1,500	66
Puerto Rico	250	125	375	(not shown)
Rhode Island	Flexible	Flexible	750	5
South Carolina	150	150	300	35
South Dakota	200	300	500	8
Tennessee	Flexible	Flexible	1,125/750	20
TEXAS	100	100	200	219
Utah	200	500	700	14
Vermont	250	150	400	4
Virginia	500	300	800	16
Washington	400	400	800	22
West Virginia	750	375	1,125	4
Wisconsin	200*	100*	300*	25
Wyoming	200	100	300	4

*may be set higher by Commissioner

TABLE IV-6 continued

Source: Capital and Surplus Requirements: Summary of State Laws and Regulations Relating Thereto (Chicago: National Association of Independent Insurers, each state separately dated).
Source for Number of Companies: Life Insurance Fact Book, p. 90.

SUMMARY

Less than	$ 300,000		4
Exactly	300,00		10
More than	300,000	but	
less than	750,000		16
Exactly	750,000		2
More than	750,000	but	
less than	1,500,000		15
Exactly	1,500,000		2
More than	1,500,000		2

Those states which have two figures in the Surplus column and Combined column require the higher amount at time of initial authorization, with the lower figure acceptable thereafter--generally specified as five years. Approximimately twenty-five per cent of the states (thirteen) are in this category. In addition, nineteen states (about forty per cent) require additional initial capital if disability insurance or accident and health insurance are written. Texas is not in this group.

In Delaware and Maine, after initial requirements are met, the Commissioner is authorized to determine the capital and surplus which each company must maintain. The decision is based on the kinds and amounts of insurance in force. New Mexico makes specific requirements for additional combined capital and/or surplus based on the annual volume of insurance in force, as follows:

Up to $10 million	$300,000
$10 to $25 million	450,000
Over $25 million	675,000

The variety of requirements indicates considerable difference of opinion among state legislatures and regulatory officials as to the proper provision for initial capitalization. States such as Arizona, Texas, and Louisiana, which have encouraged the formation of local companies, have among the lowest requirements. On the other hand, Illinois and Pennsylvania, which have high requirements, also have a large number of companies. There seems to be little discernable pattern in relation to number of companies and amount of initial capital required.

Size alone does not assure strength, nor success. The success--and also the failure--of companies of all sizes indicates that initial capital alone is not a sufficient requirement for successful operation. As Don Willmon, Chairman of the Board of United Bankers Life, expressed it, "You can be a strong little giant as well as a strong big giant."[1] (His company was referred to in its early years by some industry publications as "The Little Giant.") The difficulty of determining the necessary amount of initial capital is outlined by Kimball and Deneberg:

> There has been widespread criticism of existing capital and surplus requirements. As a result, many

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[1]Interview, Amarillo, Texas, October 27, 1973.

> states have increased their requirements, and the end of this trend is not yet in sight. Most of the changes, both proposed and enacted, have, however, been based on the roughest rules of thumb, with an assertion that existing levels are inadequate, but with virtually no scientific work to detrmine what level would be appropriate.[1]

A more critical question--because it has received even less attention--is the need for additional capital as a company expands. The above study continues:

> Up to this point, morever, formal statutory requirements of capital and surplus have been directed only to the initial phase of a company's existance. Yet requirements that are realistic for the formative stage are entirely unrealistic when the quite different question is put: what amount of capital and surplus is necessary to support safely an insurance operation with given characteristics? Up to this point in time little scientific research has been done to solve this problem.[2]

The Texas Research League study of 1958 recognized this shortcoming:

> Nor do Texas requirements recognize, except to a minor degree, that the need for adequate financial underpinning grows with the number of insurance lines a company may write. For example, Texas does not require greater financial backing for a company which writes all casualty lines than for a company which writes only one casualty line.[3]

The writer has talked with several persons who expressed a concern about proper capital in relation to a company's activities. Among these have been Don Willmon, Chairman of the Board of United Bankers Life[4] (a medium-sized company), and

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[1]Kimball and Denenberg, op. cit., p. 63.

[2]Ibid.

[3]Texas Research League, op. cit., p. 72.

[4]Interview, Amarillo, Texas, October 27, 1973.

Sam J. Winters, attorney for the Texas Life Convention (a group of the larger companies.)[1] The question arose out of a discussion as to the amount of initial capital that should be required. Both expressed the feeling that capital per se was less important than capital in relation to the activities of the company.

The problem has become more acute in recent years with increased numbers of insurance companies being components of holding companies. There is a danger that a holding company, with primary interests in fields other than insurance, will acquire a life insurance company and withdraw enough assets to jeopardize the insurance operation.

Differing Goals of Small and Large Companies

Much of the governmental regulation of industry which is ostensibly designed to "protect competition" is actually designed to "protect the competitor." As expressed by Clair Wilcox, "Whenever competition really hurts, steps are taken to moderate its force."[2] The life insurance industry conforms to this pattern: the large companies want to maintain their position; the small ones want to grow.

As brought out in the discussion of specialty policies, smaller companies have used these policies as a form of product differentiation to attract more business. Don Willmon,

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[1]Interview, Austin, June 20, 1973.

[2]Clair Wilcox, op. cit., p. 825.

whose company (United Bankers Life) had used a "Founders Policy" in its early years, said that much of the criticism came from members of the National Association of Life Underwriters who were working for companies without comparable policies. Mr. Willmon stated that much support for specialty policies came because it induced persons who needed insurance to buy it when they might not otherwise do so. He acknowledged that, " . . . the trouble is in selling it to the wrong people."[1]

This latter point is stressed by those opposed to specialty policies--primarily representatives of the larger companies, and persons whose views are similar to those expressed by Ralph Nader and former Commissioner Denenberg.[2] The representatives of the smaller companies claim they will not be able to grow as readily unless they are allowed to use such techniques as the specialty policy. The claim is often made that some of the larger companies who are now so opposed, used such techniques when they were smaller and trying to grow.

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[1]Interview, Amarillo, Texas, October 27, 1973. Mr. Willmon had used a unique plan. He first organized a mutual company. Prospective policyholders were informed that when the company reached a certain size, it would be converted into a stock company. A $10,000 policy would give the policyholder an option to buy 100 shares of stock at that time. Coupons attached to the policy, could, over a period of four years, be exchanged for the amount of cash required to buy the stock. Subsequently, there was a "Guaranteed Annual Return" of slightly less amount than each of the four coupons. This could be used in any of the four ways coupons could normally be used. The writer purchased one of those policies, and purchased the stock when the stock company was organized.

[2]Herbert S. Denenberg, "The Decline and Fall of Cash Value Life Insurance--Clarify or Perish," Best's Review, Life/Health Edition, (October, 1970): 34.

Another area of difference between small and large companies concerns investments. The smaller companies do not have the opportunity for diversification available to the larger companies, and sometimes advocate less restrictive regulation. Larger companies, with greater opportunity for diversification, and often with more capable investment counsel, are apt to favor more restriction.

The larger companies, of course, support high entry requirements. The smaller companies advocate "more competition." This argument will be decided politically, and not economically. However, it is becoming increasingly difficult to start a small company and continue successfully. One company president said it would be foolish to try to start a company with less than $1 million.[1] The difficulty of reaching "the upper tier of companies" was expressed by a former New York regulatory official. He said the best example he knew of was Allstate, and, "Of course, Allstate is backed by Sears, and for many years Sears was putting more money into it than they were getting out of it."[2]

It is possible that the smaller companies, in the practice of non-price competition, have been more innovative.

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[1]E. Jay O'Keefe, interview, Amarillo, Texas, December 20, 1973.

[2]Samual C. Cantor, Senior Vice President for Law and External Affairs, The Mutual Life Insurance Company of New York, and former Acting Superintendent for Insurance in New York State. Quoted in a letter from Suzanne T. Turner, Press and Community Relations Specialist, Mutual Life Insurance Company of New York, March 26, 1974.

Former State Board of Insurance Chairman Hunter McLean believes that to be the case. In the speech at the Twenty-fifth Anniversary Meeting of the Texas Legal Reserve Officials Association, he cites these examples:

> In 1927 at Baylor Hospital in Dallas, through the means of a small assessment association, was born hospital insurance as we have known it since. That is, policies paying for room and other miscellaneous services . . . . Incidentally, from that modest beginning at Baylor Hospital in Dallas, evolved Blue Cross and Blue Shield. Baylor was the founding patron.
>
> In 1933 the first commercial life company, a Texas limited capital company of Fort Worth, filed its hospital policy with the Texas insurance commission. Others soon followed suit . . . .
>
> A small capital stock company of Fort Worth originated polio insurance, at a modest cost annually, and was immediately swamped with applications. Other Texas companies soon entered the field, as did companies from other states. In a period of less than four years, ninety per cent of the patients in polio wards were paying their own bills through the medium of polio insurance benefits.[1]

Mr. McLean cites other examples--and significant ones--but the larger companies have also been innovators. Some advances have been in fields which required large scale operations, such as use of computers and electronic data processing. Others have been in areas which required extensive actuarial study and extensive capital, such as the variable annuity. Both actuarial study and market research may lead to new products, and it is not at all clear whether the large or the small firms will

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[1]William Hunter McLean, loc. cit., pp. 4-5.

be the most innovative in the future.[1]

Economic and Political Climate for Insurance in Texas

The life insurance industry in Texas is a powerful force, both economically and politically. It is variously regarded as the largest, or second largest, industry in the State, and has an impact through its income, its payroll, its investments, and its claim payments. Its payment of fees and taxes to the State is substantial. For the year ending August 31, 1972, all insurance companies paid a total of $76,381,603.72 in occupation (premium) taxes. The portion of this attributable to life insurance is shown in Table IV-7.

Insurance companies also paid in excess of $3 million in fees of various kinds. Approximately one-half of this represented examination fees charged against the companies for examiner's salaries and travel, and for "Overhead Assessments."[2]

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[1] Since 1967 the Institute of Life Insurance has sponsored an annual study (Monitoring Attitudes of the Public) to try to spot changes in public attitudes toward the industry and its products (as well as other ideas of general interest). The MAP Report, 1973 Series (New York: Institute of Life Insurance, 1973).

[2] Annual Report, p. 73. "The Expense of all examinations of domestic insurance companies made on behalf of the State of Texas by the Board of Insurance Commissioners or under its authority shall be paid by the corporations examined in such amount as the Board of Insurance Commissioners shall certify to be just and reasonable." (Texas Insurance Code, 1969, Article 1.16.) Similar provision is made for payment of examination of foreign companies.

TABLE IV-7

LIFE INSURANCE COMPANY OCCUPATION TAXES
FISCAL YEAR ENDING AUGUST 31, 1973

Type of Company	Taxes Paid
Domestic Life	$ 3,964,020.07
Foreign Life	29,046,357.63
Foreign Life-Article 3.25	25,705.84
Mutual Assessment Life, Health and Accident	38,164.86
Retaliatory Fees[1]	821,751.20
Stipulated Premium	134,583.19
Non-Profit Corporations	1,733,889.23
	$35,764,472.02

Source: State Board of Insurance, Ninety-Eighth Annual Report, p. 71.

An industry of such magnitude would be expected to have political influence. It does. Opinions differ as to the amount of influence wielded by various segments of the industry. The increase in the number of companies indicates existing members of the industry have not been able to erect very significant barriers to entry. The increase might also indicate the State Board is interested in "promoting" the interests of the industry in the sense of "helping it grow."

A charge that the Board is a "branch office" of the industry was made by former Chairman Larry Teaver, whose

[1]Not all of these fees (which are placed on foreign companies under the provisions of Code, Art. 21.46), are attributable to life insurance, but the Board is not able to furnish a breakdown between life and other types of insurance. Letter , Creg Hargis, Clerk, Committee on Insurance, House of Representatives, July 22, 1974.

reappointment to another term was rejected by the State Senate in 1972. According to the Austin Insurance Report,

> He blasted Members Manford and Price as being controlled by the industry. Teaver blames the insurance industry for engineering his defeat in the Senate. Teaver is further quoted as saying, "There are some insurance lobbyists paid as much as $100,000 a year just to influence that Board. When I found out what was going on, I told some of them, 'Turn in your key to the building.'"[1]

In analyzing Mr. Teaver's statement it must be remembered that the life insurance industry is not monolithic. There are at least three trade associations in the life insurance field in Texas whose viewpoints often conflict, and many other independent areas of interest. This difference of opinion will be exemplified in the next chapter in the discussion of the Guaranty Bill.

If the Board does represent the industry, the situation contrasts with that advocated by the Superintendent of the New York State Insurance Department. In an interview for the Life Underwriters Association of New York City, Superintendent Benjamin R. Schenck stated, "We are interested in protecting the public. We are policemen of the industry, not partners in progress. That's the job of the commerce department." The interview further reported that " . . . the department views itself more as an adversary of the industry and less as an advisor or mediator between the conflicting interest of buyers and sellers of insurance.[2]

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[1]Austin Insurance Report, July 18, 1972, p. 1.

[2]Nancy Q. Keefe, "Insurance Department Profile: Benjamin R. Schenck, Superintendent," The Bulletin of the Life Underwriters Association of the City of New York, March, 1974, pp. 1, 24.

Apparently this "adversary position" is departmental and not personal. According to Donald Dunham, Deputy Assistant Administrator of the Texas State Board of Insurance, many of the New York Superintendents have, "made a name and then taken a big legal job in the industry."[1]

There has not been a similar movement into the industry in Texas; perhaps because of the longer tenure in office. However, in December of 1973, the Commissioner of Insurance in Texas, Clay Cotten, resigned to take a position in industry.[2] He had served as Commissioner since 1965, and was with the Department for twelve years before that. The members of the Board are appointed by the Governor for six-year terms. Ned Price was appointed in 1960 and Durwood Manford in 1961. The Chairman, Joe Christie, was appointed by Governor Briscoe in 1973, after several of former Governor Smith's proposed appointees had been rejected by the Senate.[3]

In general, the climate for insurance in Texas is healthy. The overall growth of the State's economy had created

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[1]Interview, Austin, October 22, 1973.

[2]"Veteran Insurance Commissioner Quits," Amarillo Globe-Times, December 14, 1973, p. 5.

[3]One former member of the Board, John Osorio, who served briefly as Chairman in 1957, was recently sentenced to a two-year term in a Federal penal institution for illegal actions in connection with National Bankers Life. The violation did not involve his duties on the Board, and was a part of the "Sharpstown State Bank Scandals," which involved a number of prominent Texas officials and political leaders. A comprehensive account of this series of activities is given in Texas Under A Cloud by Sam Kinch, Jr., and Ben Proctor (Austin: Jenkins Publishing Co., 1972).

a demand which is being met both by Texas and Foreign companies. There are many companies operating profitably, although there are always some, particularly among the smaller companies, which are in financial trouble. In the next chapter the Texas regulatory system will be discussed, with particular attention to the actions taken to try to prevent financial trouble, or to counteract its effects. It will be seen that the regulations have become increasingly sophisticated for the protection of the policy-holder through the years, but there is still much "pressure" from the industry and from the legislature.

CHAPTER V

INSURANCE REGULATION IN TEXAS

Since the state constitution of 1876, which was strongly influenced by reaction against a Reconstruction Governor, the Legislative Branch of the Government of Texas has been powerful, and the Executive Branch weak. Thus, the regulatory agencies of the government originally had little power or influence. Generally, they could be described as "creatures" of the industry they were designed to regulate. Through the years they have been given additional duties by the Legislature, and some, such as the State Board of Insurance and the Banking Commission, have become quite powerful. The members of all such commissions are appointed by the Governor, except for the members of the Railroad Commission, who are elected.

This chapter will trace briefly the history of insurance regulation in Texas--with special emphasis on the Robertson Act of 1907. The present structure of the State Board of Insurance will be examined, and some of the current problems considered, particularly as they relate to solvency. Recent developments in the use of early-warning tests will be surveyed.

Some of the most important legislative acts of the last two sessions will be explained, with additional explanation of the process of reaching agreement on the Guaranty Fund Act of 1973. The Chapter will close with a description of the types of disclipinary action available to the State Board.

History of Texas Regulation

In the early days of Statehood, there were few Texas insurance companies, and most insurance business was conducted by companies from other states. Between 1848 and 1874, sixty fire insurance companies and twelve life insurance companies were licensed by the State Comptroller, but only eight were Texas companies. One of these, the Texas Mutual, was a life insurance company.[1]

Regulation was very ineffective. Many of the companies did not pay the prescribed occupation tax, or otherwise comply with the law. Governor Richard Coke, who was inaugurated January 15, 1874, mentioned this problem to the Legislature in his message of January 26:

> I feel it is my duty to call to your attention the subject of insurance in our state, and especially to some of the evils which have become apparent to the most casual observer . . . the vast bulk of the enormous business in our state is done by foreign companies . . . .
>
> No provision of law exists by which rights and remedies can be enforced in our home tribunals against these

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[1]George L. Curry, op. cit., p. 2.

corporations . . . .[1]

On May 2, 1874, the Legislature heeded the warning of the Governor, and passed the first act regulating life and health insurance companies. Initial, fully-paid capital of $100,000 was required.[2] From that time to the present almost every legislative session has seen much time and effort devoted to problems concerned with insurance companies.

No provision for regulation of insurance had been made in the Constitution of the Republic of 1836, nor in the state constitutions of 1845, 1861, 1866, or 1869.[3] However, the Constitution of 1876, under which the State is now governed, did make such provision.[4]

When this section was implemented, the state was able to make some progress in insurance regulation. Governor L. L. Ross reported to the Twenty-second Legislature at the close of his term on January 31, 1891:

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[1]Texas, Governors' Messages, Coke to Ross (Inclusive) 1874-1891, Edited by and for the Archive & History Department of the Texas State Library (Austin: Collections of the Archive & History Department of the Texas State Library. Executive Series, 1916), pp. 22-23. (Quoting from House Journal, 38-45 and Senate Journal, 32-38.

[2]Gammel's Laws, pp. 199-202. Quoted in Texas Legislative Council, op. cit., pp. 12-13.

[3]John Sayles, The Constitutions of the State of Texas, With Reconstruction Acts of Congress, The Constitution of the Confederate States, and of the United States. Annotated, 4th ed. (St. Louis: The Gilbert Book Co., 1893).

[4]"The Legislature may, at such time as the Public interest may require, provide for the office of Commissioner of Insurance, Statistics and History, whose term of office and duties and salary shall be provided by law." Article XVI, Sec. 38.

> In the insurance branch (of the Department of Insurance, Statistics and History) twenty-two insurance companies transacting business without authority of law, and in most cases without capital stock upon which to operate, and therefore wholly irresponsible, have been driven from the State and the people protected against loss by purchasing worthless insurance. They collected about $200,000 annually from the citizens and gave no benefit.[1]

James S. Hogg had been Attorney General during the Administration of Governor Ross, and succeeded him in the Governorship. Hogg had been active in driving out the "wild-cat" insurance companies, and continued the process as Governor. Some insurance companies had been attempting to quality as "benevolent corporations" in order to avoid the capital requirement, and the Commissioner of Insurance had sought advice from Attorney General Hogg. In answer to one such querry about a Kansas (fire) insurance company, Hogg replied:

> Title LIII, Chapter 1, Revised Statutes, is the only authority for incorporation of insurance companies in Texas. It requires <u>every insurance company</u> to have an actual <u>bona fide</u> capital stock of not less than $100,000, and in what its surplus shall be invested. Evidentally this is for the protection of policyholders, and applies as well to foreign as to domestic companies. It is against the spirit and letter of Texas laws for corporations to do an insurance business for profit in Texas unless her citizen policyholders are amply protected by the capital stock of at least one hundred thousand dollars which cannot be reduced by any prescribed rules below that amount.[2]

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[1]Texas, <u>Governors' Messages</u>, p. 682. The Governor also mentioned that the Twentieth Legislature had created a Bureau of Agriculture, and added it to the Department of Insurance Statistics, and History.

[2]Letter, James S. Hogg to L. L. Foster, Commissioner of Insurance, February 26, 1887. <u>Addresses and State Papers of James Stephen Hogg</u>. Edited with a Biographical Sketch by Robert C. Cotner (Austin: University of Texas Press, 1951), p. 39.

When Hogg opened his campaign for Governor, he spoke of his actions as Attorney General against certain corporations:

> My first work . . . was against illegal fire and life insurance companies, generally called "wildcat" concerns. Then there were about forty of them operating in Texas in violation of the law. By the aid of an efficient and faithful Commissioner of Insurance through the courts, I effected the extermination of every one of them within twelve months . . . . By this work the Commissioner informs me that the people have saved at least $250,000 per year.[1]

As previously mentioned, many mutual assessment and fraternal associations were formed around the turn of the century. By 1903, eighty-five fraternal groups were selling life insurance in Texas.[2] Some of these, such as the "Slavonic Benevolent Order of the State of Texas," had other purposes as well.

> While the SPJST (the abbreviation of its Czeck name) was organized primarily for the purpose of offering its members reliable and economical life insurance . . . it was also organized for the purpose of teaching and instructing its members in their duties as American Citizens and installing patriotism and American citizenship into their hearts.[3]

In the first decade of the Twentieth Century Democratic leaders of Texas increasingly identified with the Populism of William Jennings Bryan. There was a great deal of sentiment for "control" of large corporations. In 1905 the Legislature

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[1] Ibid., p. 66

[2] Hugh Williamson, The Story of Insurance in Texas (Dallas: John Moranz Associates, 1954), p. 41.

[3] Ibid., p. 42., quoting J. F. Chupick, Secretary of the Company.

raised taxes on the intangible assets of corporations, levied a one per cent tax on the gross receipts of railroads, and a two per cent tax on the gross receipts of insurance companies. A special session later in the year raised the tax on the gross receipts of life insurance companies to 2.25 per cent.[1]

The combination of the Populist movement and the reaction to the exposures of the Armstrong investigation (as outlined in Chapter III) led to many changes in insurance laws in the various states. One of the most far-reaching was the Robertson Law of 1907 in Texas.[2] A strong feeling existed in the State that much money was "siphoned" out of Texas to New York because the Eastern companies collected so much more in premiums than they paid out in benefits. Thomas Benton Love, Commissioner of Insurance and Banking, reported that over a twenty-year period ending in 1907, the three largest New York companies doing business in Texas--New York Life, Equitable and Mutual--had collected approximately $52,000,000 while paying out only $16,500,000.[3]

Several states considered some form of compulsory investment requirement, but Texas was the only one to pass

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[1]Alwayn Barr, Reconstruction to Reform: Texas Politics 1876-1906 (Austin: University of Texas Press, 1971), p. 234.

[2]Chapter 170, General Laws of Texas of 1907.

[3]James A. Tinsley, "Texas Progressives and Insurance Regulation," Southwestern Social Science Quarterly 36 (December, 1955): 238-9.

such a law. It required that all life insurance companies doing business in the State must invest seventy-five per cent of the reserves on Texas business in Texas securities, and, with certain exceptions, deposit them in the State, where they would be available to pay Texas claims if needed--and also be subject to State and local taxes.

The controversy was bitter, but the law was passed. A number of the foreign companies (21 out of 46) immediately withdrew from the State. They cited the deposit feature as the chief reason for the withdrawal, but when that feature was removed in 1909 none of them returned.[1]

The results of the Robertson Law were widely hailed in Texas. Insurance Commissioner Love reported that within a year after the new law went into effect, insurance loans on farm mortgages were over $1,125,000. He said this was "$256,675.94 more than the 21 companies which had left the State had loaned during the 30 years they had done business in the State."[2]

There is a difference of opinion as to whether the Robertson Law was primarily designed to assure more adequate service from the foreign companies or to promote the domestic companies. Whatever its aim, it certainly helped achieve the latter purpose. The five domestic companies in 1906 increased

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[1] Ibid., p. 243.

[2] Ibid.

to eleven in 1909 and twenty-one in 1911. Their share of the business written increased from twenty-five per cent ($15.8 million) prior to the passage of the law, to forty-nine per cent ($46 million) in 1909 and fifty-one per cent ($54 million) in 1911.[1]

The foreign companies which remained in the State did not consider the law unduly restrictive, and their business increased along with that of the domestic companies. The Dallas representative of the Hartford Life Insurance Company wrote Commissioner Love on March 20, 1909, that ". . . Texas now has one of the best insurance codes of any state in this union."[2]

More recent analysis has indicated that the results from the standpoint of promoting investment in Texas were not as substantial as formerly believed. Professor Winston C. Beard has studied the Robertson Act and its aftermath extensively. His Ph.D. dissertation at the University of Illinois[3] dealt with this subject, and he served as a consultant to the State of Arkansas when a similar law was being considered in in that state. His most recent study was published after the

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[1]Texas, <u>Annual Report of the Commissioner of Insurance and Banking</u>, (1907-1912).

[2]Letter, William H. Patterson (Dallas) to Love (Austin), March 20, 1909. Quoted in Tinsley, loc. cit., p. 243.

[3]Winston Clingan Beard, "The Financial and Economic Effects of Geographical Restriction Upon the Investment Policies of Life Insurance Companies" (Ph.D. dissertation, University of Illinois, 1961).

repeal of the Robertson Law in 1963. He concluded that,

> . . . very little, if any, of the increase in investments by life insurance companies can be attributed to the Robertson Law. The increase that did occur following its enactment was so far in excess of the requirements of the law that other factors are presumed to have caused the investment growth.[1]

Professor Beard points out that the reasons for the repeal of the law grew out of the same sort of process which brought it into being: Texas companies expanding into other states were being threatened with retaliatory provisions of a similar nature. Following the invoking of such provisions in Arkansas, the Texas Life Convention pointed out to the Legislature that, "If other states follow the lead of Arkansas, it will be disasterous for Texas and Texas life insurance companies."[2] The repeal bill was signed by Governor Connally on May 28, 1963.[3]

Regardless of the effect on investments, the Robertson Law stimulated the domestic life insurance business, but also drew attention to the industry and the need for effective regulation. In 1923 the regulatory functions pertaining to insurance and banking were separated, and a Department of Insurance created, under the direction of a Commissioner of Insurance.[4]

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[1]Winston C. Beard, "An Epitaph for the Robertson Law," Journal of Risk and Insurance 32 (December, 1965): 595-608.

[2]Ibid., p. 605.

[3]Senate Bill 27, 58th Legislature, Regular Session, 1963.

[4]Acts 1923, 38th Legislature, 3d Called Session, Ch. 19.

In 1927 a Board of Insurance Commissioners was created. It consisted of a life insurance commissioner, a fire insurance commissioner and a casualty insurance commissioner, all appointed by the Governor. The life insurance commissioner was the chairman.[1] This body administered a group of laws which multiplied rapidly in the late 1940s, and brought increasing recognition of the need for more systematic procedure.

The growth of Texas after World War II was accompanied by an increase in the number of domestic companies and a return of several of the large Eastern Companies. Eleven of them had returned by 1951, including four before 1947.[2] As a result of this growth, the regulatory structure was not adequate to meet the increased burdens placed upon it. In 1951 the Legislature enacted the first Insurance Code for the State. It was described as,

> An Act arranging the Statutes of this State affecting the business of insurance into appropriate Chapters and Articles into a consistent whole and under a single code, making such editorial changes in context as are necessary to that accomplishment; preserving the substantive law as it existed immediately before the passage of this Act except as to laws affecting the business of insurance passed at the Regular Session of the 52nd Legislature, and as to such laws just passed, preserving same and each of them, and containing all details appropriate to achievement of those purposes, providing for severability of the different Articles or parts of Articles so that unconstitutionality of

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[1] Acts 1927, 40th Legislature, Ch. 224.

[2] William R. King, "History and Development of Insurance Law in Texas," in Vernon's Annotated Texas Statutes, Vol. 14. (Kansas City, Mo.: Vernon Law Book Co., 1963), p. 12.

> one or more shall not affect the remainder of the Act; repealing in Section 4 hereof, certain Statutes and Acts together with all laws or parts of laws in conflict herewith; and declaring an emergency.[1]

This Code has been amended many times. In 1969 the State Board of Insurance prepared the Texas Insurance Code 1969. The Preface states, over the name of the Commissioner of Insurance:

> This publication has been prepared as an unofficial revision of the original code which was adopted in 1951. It contains all amendments to the date of adjournment of the 61st Legislature, September 9, 1969.
>
> This volume also covers other statutes which relate to insurance. The Rules of Practice and Procedure Before the State Board of Insurance and the Commissioner of Insurance are also included for convenient reference. The Business Corporation Act and the Non-profit Corporation Act are not included in this publication, but their provisions do govern insurance companies when not in conflict with this code.[2]

Major revisions in the legislation itself were made by the Fifty-fourth Legislature in 1955. These were largely based on a study made by the Texas Legislative Council in 1954, as directed by the Fifty-third Legislature.[3] The Council

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[1]House Concurrent Resolution No. 179, 52nd Legislature, 1951, p. 868, Ch. 491. Also, Vernon's Annotated Texas Statutes. Vol. 14 and 14A.

[2]Texas Insurance Code 1969, p. iii. The State Board prepared a listing, with reproduction of the Acts, of "Insurance Legislation Enacted by the 62nd Legislature of Texas" in December, 1971, and a similar listing after the 63rd Legislature. Commissioner Cotten stated in an interview in Austin, June 20, 1973, that he felt it was time to prepare a new "Code," but this has not yet been done.

[3]House Concurrent Resolution 36, 53rd Legislature, 1954, First Called Session.

had been directed to make the study because of an increasing concern in the State--in the industry, the Legislature and among a great many citizens--about various types of insurance "promotions" and an apparent increase in insolvencies. The Fifty-fourth Legislature passed sixteen separate insurance bills. Among the more important were bills to increase the initial capital and surplus required, to give the Board of Insurance Commissioners more control over capital and surplus and to strengthen the examination procedure.[1]

In 1956, the Texas Legislative Council prepared a report on the adequacy of the previous year's legislation. The Council concluded that the Fifty-fourth Legislature had acted affirmatively with respect to 82.5 per cent of the recommendations the Council made which warranted legislative attention.[2] Despite these improvements, Texas continued to be troubled by company insolvency. From 1954 to 1958 twenty-three Texas insurance companies or organizations were placed in receivership.[3] Something more was needed in the way of regulatory control.

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[1]William R. King, loc. cit., p. 15.

[2]Texas Legislative Council, A Review of the Adequacy of Insurance Legislation Enacted by the 54th Legislature. A Report to the 55th Legislature, 1956, Sec. 3(c) of Summary.

[3]William R. King, loc. cit., p. 15.

Present Administrative Organization and Procedure

An entirely new administrative structure was created by the Fifty-fifth Legislature in 1957. The State Board of Insurance Commissioners was changed into the State Board of Insurance, whose three members were to operate as a unit. They were to appoint a Commissioner of Insurance who would be the Chief Executive and Administrative Officer, and subject to the Board's supervision.[1] This arrangement has produced a stability that is lacking in many states. Clay Cotten served as Commissioner from 1965 to December, 1973, following twelve years in the Department prior to that time.

While interviewing Don Dunham, Deputy Assistant Administrator of the State Board of Insurance, in the fall of 1973, the writer questioned the allegation in an article in The Wall Street Journal that the "average tenure of State Insurance Commissioners was two years."[2] Mr. Dunham checked a directory showing the year of appointment of each of these officials, and determined this to be true at that time. With the exception of Texas, Oklahoma, New Mexico, and Colorado there has been a very high turnover of state commissioners. At that time thirty-eight of the incumbents had been appointed in

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[1]Insurance Code 1969, Arts. 1.02, 1.03, 1.04, and 1.09.

[2]William Blundell and Priscilla Meyer, "The States' Regulation of Insurance Companies Often Viewed as Farce" The Wall Street Journal, August 21, 1973, p. 1.

1971, 1972, or 1973.[1]

Former Board Chairman Hunter McLean praised the stability of the Texas system:

> The Commissioner, an appointee of the Board, is not subject to dismissal with each change of Governors, but instead, accumulates experience in the technical and complex business of insurance, knowledge of his personnel, and may expect to hold the position so long as good judgement and conduct are exercised.[2]

Mr McLean also frankly acknowledged the political impact on regulation:

> I do not believe you will be able to successfully sort political influences from insurance economics. Political decisions determine much of the economic results of regulated institutions . . . . I do not oppose insurance regulation; believe it to be desirable. I am convinced that much of it is absurd, conflicting and counterproductive to its major justification, to wit: Solvency of insurers.[3]

In the last year of Governor Smith's administration (1972), several of his proposed appointees to the State Board were rejected by the Senate. Such action definitely indicates political influence at the policy-making level--where it clearly belongs.

One of the continuing controversies involving the regulatory process concerns the alleged tendency of the regulatory agency to become the "captive" of the industry. Such a process has been described by Marver H. Bernstein as the almost-inevitably-

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[1]Interview, Austin, October 23, 1973.

[2]Letter, November 2, 1973.

[3]*Ibid.*

recurring "life cycle" of regulatory agencies.[1] The wide range of acceptance of such a thesis is indicated by this statement in a report of the Third Annual Summer Economics Institute for Law Professors:

> When Professor Alchian (Armen A. Alchian, University of California, Los Angeles) proffers an opinion, it is usually only after several caveats and disclaimers. For example, when pressed by Justin Sweet of the University of California Law School, he admitted that, yes, he subscribes to the belief that government regulatory agencies are often taken over and dominated by whatever agencies it is they are supposed to regulate--a position he holds in common not only with Milton Friedman, but with Ralph Nader.[2]

Not all students of the regulatory process accept the "life cycle" hypothesis, however. There are challenges on two grounds: (1) the explanation is just too pat--"an old Progressive slogan elevated to a dogma," or (2) (an approach attributed to Professor Jaffe of the Harvard Law School) reliance on the affected interests does not evolve; it begins with the establishment of the agency.[3]

A statement by management consultant Peter Drucker helps explain some of the difference of opinion about the influence of the industry, so-called "political pressure."

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[1]Marver H. Bernstein, Regulating Business By Independent Commission (Princeton: Princeton University Press, 1955).

[2]Edwin McDonald, "Bringing Law Profs Up to Date," The Wall Street Journal, July 23, 1973, p. 8.

[3]Samuel Krislov and Lloyd D. Musolf, eds., The Politics of Regulation (Boston: Houghton Mifflin Co., 1963), pp. 61-2.

> If I were to have a criticism of the American businessman, it is that he has made no attempt to understand the political process. He attempts to influence it without understanding it.[1]

Many groups in Texas have tried to influence the political process of insurance regulation, but as mentioned in the previous chapter, the industry does not speak with one voice. There are at least three organizations of life insurance companies whose interests often do not coincide, and there are many other sources of "pressure" on regulatory officials and the legislature. Furthermore, the legislature itself is often a source of pressure.

Representatives of smaller companies tend to criticize the Board as being dominated by the large companies. On the other hand, an indication of influence of smaller companies is the "grandfather clause" in the Insurance Code pertaining to initial capital and surplus. When these provisions were raised in 1955 from $25,000 capital and $12,500 surplus to $100,000 of each, companies existing prior to May 15, 1955, were not required to provide for any increase.[2] In a similar manner, the Guaranty Fund which is described later in this chapter, does not include the non-legal reserve companies. They wanted to be left out.[3] Since political

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[1]"Inside Peter Drucker," Nation's Business, March, 1974, p. 63.

[2]Insurance Code 1969, Art. 3.02, Sec. 2.

[3]Austin Insurance Report, February 29, 1972: "Robert Sneed, Texas Association of Life Insurance Officials, said that mutual assessment and stipulated premium companies want to be left out of such legislation. He said that his group opposes the preassessment section of the bill, saying, "We would like to be left just like we are."

action cannot be completely neutral, it must be conceded that political pressures will be exerted for economic ends.

Insurance regulation in Texas covers numerous types of activity in addition to life insurance. All are administered by the same Department, but sometimes in quite different ways. The Chief Clerk of the Insurance Committee of the House of Representatives described the basic difference in these terms: property and casualty companies are subject to "front-end" regulation, that is, rate regulation; life companies are subject to "back-end" regulation, or regulation of administration, investments and operations.[1] The regulation of fire and casualty companies takes more of the time of the Board, because of the involvement with rates.[2]

Current Problems

The Texas Insurance Code 1969, With Related Acts and Rules of Procedure covers over 600 pages. Almost 500 of these deal in some way with life insurance. This paper will not attempt to cover all the topics which are included in the life sections. Instead, the writer intends to discuss a few of the most critical current problems, to consider several recent legislative acts designed to alleviate those problems and to discuss briefly the types of disciplinary action available to the State Board.

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[1] Forrest C. Roan, Interview, Austin, June 18, 1973.

[2] Durwood Manford, Interview, Austin, June 22, 1973.

Solvency is a subject of prime concern in any discussion of life insurance regulation. While entry conditions and operating conditions both have an influence, much attention has been focused on capital and surplus requirements. The statutory requirements for initial capital and surplus were listed in Chapter IV. As indicated, the requirements in Texas are among the lowest in the nation. Yet size alone is no guarantee of successful operation. As D. J. Hundahl, Jr., President of National Security Life and Accident Insurance Company, expressed it, "After all, if size alone is the criteria for an insurance company, we only need one."[1]

The wide range of initial capital requirements indicates considerable difference of opinion as to the necessary capital. As indicated in the previous chapter, much current thinking centers on the relation of capital to the size and type of operations rather than to size per se.

Herbert S. Denenberg, in an article written before he was Insurance Commissioner of Pennsylvania, recognized the need for more study to determine adequate capital. He mentioned the recently enacted Michigan requirements for $1,000,000 capital and $500,000 surplus.

> These figures have appeal to a regulator's insatiable appetite for conservatism. But why not the more conservative $1,000,000/$2,000,000 New York requirement? Or perhaps $5,000,000/$10,000,000? And why not smaller figures? Can the insurance enterprise be safely operated

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[1]Letter, October 25, 1973, D. J. Hundahl, Jr., to D. J. Willmon, Dallas.

> on smaller capital? Should the requirements of the enterprise be entirely discretionary with the commissioner (as in some European countries)?
>
> These questions can be answered in a rough qualitive sense, but would be more acceptable if backed by statistics of surplus actually needed, placed in jeopardy, and expended by young companies. More information is needed if this, and many of our other conclusions about regulation, are to be firmly accepted.[1]

An aspect of initial operations which is quite important, but is often overlooked, concerns the ability or experience of those making application to charter a new company. Article 3.04 of the Texas Insurance Code provides:

> Sec. 3. In considering any such application, the Board shall within thirty (30) days after public hearing, determine whether or not:
> (a) The minimum capital and surplus, as required by law, is the bona fide property of the company;
> (b) The proposed officers, directors and managing executive have sufficient insurance experience, ability and standing to render success of the proposed company profitable;
> (c) The applicants are acting in good faith.[2]

The writer querried the Chairman of the State Board about the number of applicants who might have been rejected for reasons other than lack of required capital. The following reply was received:

> . . . we have not maintained any specific statistics on this matter. However, I am informed by a staff

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[1]Herbert S. Denenberg, "How to Rewrite An Insurance Code: Comment," Journal of Risk and Insurance 34 (December, 1967): 562.

[2]Insurance Code 1969, Art. 304, Sec. 3.

> member familiar with this matter that within recent years some applicants have been rejected by the application of the criteria provided in such statutes.[1]

These criteria admittedly provide much leeway for value judgment. Chairman Christie's letter indicates they are not rigidly applied. Fear of legal action in case of an adverse ruling might be a deterrent. Yet such provisions are a strong tool for the use of the State Board.

Even if all the initial criteria are adequately satisfied, many factors may cause trouble for a company. After the initial requirement of $100,000 capital and $100,000 surplus is met, the only continuing requirement relates to capital. Since some surplus is required to cover the expenses of every new life insurance policy written, a company must have surplus over and above its capital. If this capital becomes impaired to the extent of thirty-three and one-third per cent, the company must "make good such impairment within sixty days by reduction of its capital stock." It cannot be reduced below the statutory minimum, however, without forfeiting the privilege of writing new insurance.[2]

A doctoral dissertation at the University of Texas, which was mentioned in Chapter II, listed a number of causes of insurance company failure.[3] The study is well-illustrated

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[1]Letter, Joe Christie, Chairman, State Board of Insurance, June 5, 1973.

[2]Insurance Code, Art. 3.60.

[3]See p. 73. See also p. 219, Letter from William Hunter McLean, August 8, 1974.

with examples from the decade of the 1950s. Even a cursory examination of this data would lead one to conclude that no set of regulations could protect adequately against all of these possibilities, yet regulatory officials must seek to do so.

The officials would prefer to detect conditions leading to bankruptcy in an incipient stage in order to minimize loss to policyholders. In recent years several states have been seeking to develop "early-warning" tests for such a purpose. Texas has been among the leaders in this endeavor.[1] Similar concern in other states is indicated by a series of articles in The Journal of Commerce.

This business newspaper published a series of articles by state insurance commissioners dealing with the regulatory problems they face. Because of wide-spread interest in the problems, the articles were reprinted together in pamphlet form. Of the total of seventeen, four dealt with solvency, or surveillance tests.[2]

Commissioner Cotten explained that the normal examination of a life insurance company may take several months. During such a period, conditions in a company facing financial difficulties could deteriorate rapidly. Now, however, combination of

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[1]Clay Cotten, Interview, Austin, June 20, 1973. Sam J. Winters, Interview, Austin, June 20, 1973.

[2]"The Commissioners Speak," A Special Report by the Journal of Commerce. Articles reprinted from the Journal of Commerce, New York.

computer accounting techniques and a recent statutory requirement have now made it possible to tell "in a week's time" if a company is in trouble, according to Mr. Cotten.[1]

The Sixty-second Legislature in 1971 enacted a piece of legislation which Commissioner Cotten said was "one of the most significant acts in the last decade."[2] He was referring to the Assets Protection Act, which has the following purpose:

> This Act is for the purpose of requiring insurers to have and maintain unencumbered assets in an amount equal to reserve liabilities; to provide preferential claims against assets in favor of owners, beneficiaries, assignees, certificate holders, or third party beneficiaries of insurance policies; and to prevent hypothecation or encumbrance of assets in excess of certain amounts without prior written order of the Commissioner of Insurance.[3]

The National Association of Insurance Commissioners throughout its existance has worked for uniformity of state insurance laws, and for improvement of the entire regulatory process. In recent years the creation of adequate early-warning tests for insolvency has been the subject of much concern. In 1973 the NAIC contracted with the management consultant firm of McKinsey & Company to study the entire process of state regulation of insurance, and to seek specifically to

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[1]Interview, Austin, June 20, 1973.

[2]Ibid.

[3]Senate Bill 839, 62d Legislature, 1971, Sec. 2. Mr. Cotten stated in the June 20 interview in Austin that the Century Life Insurance case had brought on this legislation. That company had hypothecated over $11 million in FHA loans and other assets. He further stated that this Act, for the first time, gave real meaning to the term "legal reserve life insurance company."

devise more adequate tests of surveillance than those already in use in Texas and a few other states.

This part of the McKinsey study, "Improving the Life and Health Early Warning System," was released in the spring of 1974. The Introduction to the Report states:

> Judging from experience during the past decade, the recommended system would be dramatically more effective in distinguishing between troubled and sound companies than the current system. As shown in the final pages of this report, half of the improvement in effectiveness results from dropping ineffective tests; the other half results from adding and modifying tests and altering the cutoffs for determining exceptional values.[1]

The system is designed with a basic purpose of "distinguishing between troubled and sound companies." Then there is a "broad variety of further analyses" for the troubled companies to "determine the source of the difficulty and its degree of severity."[3] To determine the effectiveness of given ratios in distinguishing between troubled and sound companies, the study used the historical approach, i.e., comparing the ratios of a group of companies that became insolvent during

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[1]McKinsey and Co., Inc., "Improving The Life and Health Early Warning System. National Association of Insurance Commissioners." (n.p.: McKinsey and Co., Inc., April 12, 1974), p. 1.

[2]Ibid., p. 2.

[3]Ibid.

the past decade with the ratios of a group of financially sound companies.[1]

The McKinsey analysis develops a "priority" designation for those companies most likely to require further examination. This would have identified about eighty per cent of the insolvents in each of their last four years prior to insolvency.[2]

The regulation of investments is another area of concern, and the subject of considerable controversy. Authorized investments and loans for Texas life insurance companies are listed in Article 3.39 of the Insurance Code. Article 3.40 authorizes holding of real estate, and Article 3.40-1 makes additional provisions for investment in income-producing real

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[1] Ibid. Prior to the release of the McKinsey report, the writer conducted such a study of Texas companies, although on a much less sophisticated basis. Complete data was not available on all the companies which had failed, so the information in the Texas Blue Book of Life Insurance Statistics was used. Thirteen items are shown for each company. Taking the data for three years, a process of Linear Discriminate Analysis was used to determine the probability of a company being a success or failure. The sample examined included all legal reserve companies in Texas for the years 1963-1972. The results achieved were able to explain only twenty per cent of the probability of success or failure. Detailed results are not presented, as the McKinsey study has provided much more useful analytical tools. The type of analysis used by the writer is described in David R. Cox, The Analysis of Binary Data (London: Methuen and Company, 1970). Dr. Frank Landrum of West Texas State University assisted the writer in adapting the process for the specific purpose of this study. An excellent example of the use of linear discriminate analysis for a similar purpose is described in Edward I. Altman, "Predicting Railroad Bankruptcies in America," The Bell Journal of Economics and Management Science 4 (Spring, 1973): 184-211.

[2] McKinsey & Co., "Early Warning System," pp. 11-12.

estate.[1] A company may invest "Any of Its Funds and Accumulations" in the following types of securities:[2]

1. U. S. Bonds and Obligations Guaranteed by the United States
2. Canadian Bonds (Dominion, province or city)
3. State, County, and City Bonds[3]
4. County, City and School District Bonds[4]
5. Bonds of Educational Institutions
6. Revenue Bonds, etc., of Educational Institutions
7. Bonds and Warrants of Municipally Owned Systems
8. Paving Certificates
9. Bonds Issued Under Federal Farm Loan Act
10. Corporate First Mortgage Bonds, Notes and Debentures
11. Shares of Savings and Loan Associations
12. Bank Stocks
13. Debentures of Public Utility Corporations
14. Preferred Stock of Public Utility Corporations
15. Securities Not Otherwise Specified (". . . shall not exceed one per cent (1%) of the admitted assets of any such life insurance company; and provided further that the investments authorized by this Section shall not exceed the lesser of (a) five per cent (5%) of its admitted assets, or (b) the amount of its capital and surplus in excess of Two Hundred Thousand Dollars ($200,000) . . . .")

15A. Other Bonds
  (1) Inter-American Development Bank Bonds
  (2) State of Israel Bonds

16. Securities Authorized by Special Acts of the Legislature (thirteen citations to specific laws)
17. Other Securities Specifically Authorized by Law

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[1]Insurance Code, Articles 3.39, 3.40 and 3.40-1.

[2]Insurance Code, Article 3.39, Part I, Subdivision A.

[3]"The bonds of any state, county, or city of the United States."

[4]"Any bonds or interest-bearing warrants issued by authority of law by any county, city, town, school district or other municipality or subdivision . . . under the laws of any state . . .; provided legal provision has been made by a tax to meet said obligations."

Other portions of this Article pertain to investment of the following types of funds:

Part I
- B. Policy Reserves and Surplus
- C. Capital, Surplus and Contingency Funds Over and Above Policy Reserves
- D. Capital, Surplus and Contingency Funds Not to Exceed Ten Per Cent
- E. Minimum Capital and Surplus
- F. General

Part II Authorized Loans[1]

The Sixty-third Legislature, in what came to be referred to as the "Surplus-Surplus Bill," amended Part I, Subdivision C, of the Insurance Code:

> . . . to permit investment of surplus funds over and above the greater of either (a) ten per cent of admitted assets . . . or (b) the minimum capital and surplus requirements for incorporating a life insurance company . . . in the capital stock, bonds, and other obligations of any one or more solvent corporations.[2]

Thomas Thompson, former Editor of the Amarillo Globe-Times, whose articles about the Texas life insurance industry influenced the writer to begin this study,[3] was very critical of the above-listed investment provisions. Among his censorious remarks were the following:

> An overhaul of the investment provisions of the insurance code is long overdue. They are inadequate, they are permissive and leave too much to the judgement and discretion of the insurance commission staff.[4]

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[1] Ibid., Part I, Subdivisions B-F; Part II.

[2] Senate Bill No. 480, 63rd Legislature, 1973.

[3] See p. 18.

[4] Thomas H. Thompson, "Insurance Scandals Prove Ease of Lassoing Fast Bucks," Amarillo Globe-Times, April 18, 1972.

> There is nothing in the Texas Insurance Code that requires a balanced investment or diversification of investments. The New York Insurance Code emphasizes that life insurance companies' portfolio shall contain securities "wherein the speculative elements are not predominant." You look in vain for this specific kind of language in the Texas code.[1]

A vigorous criticism was also expressed by E. J. Reeves, President of Commercial Travelers Life Insurance Company:

> . . . it must be admitted that regulations as established under Article 3.39 are outdated and narrow; some parts containing such wretched grammar that they are almost devoid of clear understanding. It is said, though I personally could not vouch for the same, that Texas has perhaps the narrowest and most awkward investment statute of any of the fifty states . . . .
>
> I have observed over the years that many feeble efforts to improve this statute and it has always fallen short of the needed. (sic) It is well said in the industry concerning the matter of amending 3.39, "Hell, go ahead, there ain't nothing you can do to make this section any worse." That probably is a statement a bit too strong, yet it does not fall far short of the mark.[2]

A different position is taken by representatives of some of the smaller and medium-sized Texas companies. President D. J. Hundahl, Jr., of National Security Life and Accident Insurance Company, regards the 1973 change as an improvement:

> Our investment statutes were improved considerably by the passing of S.B. 480 . . . . It is my feeling

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[1]Thomas H. Thompson, "Insurance Code Requires No Balanced Investment," Amarillo Globe-Times, April 19, 1972.

[2]Letter to Don J. Willmon, Dallas, October 25, 1973.

> that funds that are subject to dividend declaration should not be restricted in any way and that the law should assume that minimum surplus requirements are adequate to protect the policyholders and the public.[1]

Some of the criticism of these investment provisions is undoubtedly engendered by the conflicting purposes they seek to serve. Kimball and Denenberg explain it as follows:

> Investment regulation has long presented the horns of a dilemma to the insurance commissioners and to the legislature. Either legislation and regulation must be so detailed and strict as to put handcuffs on the competent investment managers of strong and well-run insurers, or so general and lacking in detail as to make it possible for inexperienced investment personnel to endanger seriously the interests of insureds and the public.[2]

Similar controversy surrounds investment in real estate. The industry average is three per cent of admitted assets.[3] The Texas Code permits thirty-three and one-third per cent with provision for this figure to be increased to fifty per cent with advance approval of the State Board of Insurance.[4] Many states have lower limits. The 1956 study of the Texas Legislative Council showed that of thirteen states which were picked for comparison, ten set a lower limit than Texas, with figures ranging from ten to twenty-eight per cent; two set no limit, and one made no provisions in its statutes pertaining to real estate investment.[5]

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[1] Letter to Don J. Willmon, Dallas, October 25, 1973.

[2] Kimball and Denenberg, Insurance, Government and Social Policy, p. 137.

[3] Best's Reports, Life/Health 1973.

[4] Insurance Code, Art. 3.40.

[5] A Report to the 55th Legislature, p. 58.

Of the top fifty Texas companies at the end of 1972 five owned no real estate. For the other forty-five, the portion ranged from 0.03 per cent to twenty-six per cent of admitted assets, for an average of 5.34 per cent.[1]

Spencer Kimball concluded, after studying various state restrictions on real estate ownership:

> From the earliest insurance company charter in the United States, strict limitations were imposed upon acquisition of real property. These laws long antedate the law's real concern for the security of insurance company assets; rather, they seemed to effectuate a policy like that of the English mortmain acts, to keep real property out of the control of institutions which might have perpetual life.[2]

Mr. Reeves, whose letter was quoted above, favors more liberal consideration for real estate. "The section actually mitigates against investment and consideration for Texas real estate albeit a fact that the very basis of our wealth in this state is indeed in real estate."[3] Don Willmon stated there is nothing wrong with having more than three per cent in real estate. He said each situation should be analyzed individually, and he felt there was more of a tendency for the

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[1] Best's Reports, Life/Health 1973.

[2] Kimball, Insurance and Public Policy, pp. 69-70.

[3] Letter, E. J. Reeves to Don J. Willmon, October 25, 1973.

Insurance Department to undervalue it than to overvalue it.[1] It is true that, historically, land has been a good investment in Texas. A recent study reported in Texas Parade surveys the current situation and concludes:

> Speaking generally, the rise in land prices has been spectacular. Choice Texas land doubled in price between 1963 and 1970. Between 1970 and 1972, it doubled again. In another two years, it had doubled again.[2]

Commissioner Cotten told of the difficulties with Girard Life involving real estate. The company owned some "junky real estate," which it was required to remove from its admitted assets. This left one very valuable piece of real estate (about 100 acres near downtown Dallas) comprising about eighty per cent of the company's assets. Following some "bad decisions," the company was placed in receivership December 31, 1970. The land was carried on the company's books for $30 million, but the best offer the Commissioner could get for it was $8 million. Rather than accept that, with considerable

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[1]Interview, Amarillo, Texas, October 27, 1973. If underevaluation is widespread, it may be an over-reaction to a prior situation. The Texas Legislative Council 1956 Report stated, "Regulations governing appraisal of real estate owned by insurance companies were non-existent prior to 1955. The situation was capitalized on by a number of unscrupulous operators in the post World WarII years until the enactment by the 54th Legislature of laws designed to stop such practices. Evidence disclosed, as reported in the Legislative Council's 1954 study, that flagrant overevaluation of real estate, particularly of home office buildings, was a primary or contributing cause of failure of several companies." Texas Legislative Council, Report to the 55th Legislature, pp. 47-8.

[2]Dudley Lynch, "Gimme Land, Lot'sa Land. Land Fever is Rampant--And The Prices Just Keep Climbing Higher," Texas Parade, June, 1974, p. 15.

loss to policyholders, he set out to try to work out something else.[1]

The results are described in the Texas Star of January 28, 1973. Commissioner Cotten finally worked out an arrangement with John D. MacArthur of Chicago. According to Cotten:

> Mr. MacArthur shared my conviction that the potential value of the real estate through development would ultimately restore the policyholders to a situation of no loss whatsoever. In fact, he was so convinced that he in effect guaranteed to accomplish this within a ten year period. He guaranteed to make the policyholders whole within such period in the event that he fails to realize the value by development of the land.[2]

Board Chairman Christie said he wanted to "emphasize strongly that this was an excellent example of how a talented and dedicated Commissioner like Mr. Cotten has worked hard to save policyholders."[3]

These various views about real estate confirm the observation of Mr. Willmon quoted above, that it is not the percentage of real estate which matters, but the particular situation.

In considering current problems, the matters of ascertaining costs and disclosing costs to the buyer, as described in Chapter II, must not be overlooked. Both of these problems

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[1]Interview, Austin, June 20, 1973.

[2]Gordon Fulcher, "Search for A Savior; Insurance Commission Uses New Concept To Help Protect Company's Policyholders," Texas Star, January 28, 1973, p. 9.

[3]Interview, Austin, June 20, 1973.

merit continued study. Regulatory officials must continue to work closely with interested groups in the industry and in the accounting profession to alleviate these problems.

The Order of the State Board to use the Interest Adjusted Cost Comparison Index has already been cited.[1] Accompanying this Order was a letter from the Commissioner specifying minimum acceptable requirements for complying with the Order. Among them was the following:

> 4. Any proposal or comparison of life insurance policies shall be in written form and shall contain the following statement or one of the same substantial meaning in a clear and conspicuous manner: "The amounts and calculations reflected herein show a relationship of the premiums, cash values and other policy values. Such should not be considered to represent the cost of any insurance or annuity policy proposal."[2]

This required disclaimer is evidence that the Cost Comparison Index is no more than an index. Additional study is needed to determine actual cost figures which are satisfactory.

The whole question of accounting is involved in the question of Board examination of companies. Examinations must be made every six months for the first three years of operation; once a year for the fourth through sixth years of operation, and thence once every three years. It may be done more

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[1]State Board of Insurance, Order No. 26809, March 28, 1974.

[2]Letter, Don B. Odom, Commissioner of Insurance, to "All Companies Authorized To Write Life Insurance In the State of Texas," attached to Board Order No. 26809.

often as deemed desirable.[1] The variation in examination requirements is recognition that some companies require examination more than others. A study by a Professor of Insurance at the University of Pennsylvania advocates even more flexibility. He claims the examination system of most state insurance departments is "deficient in every respect,: and calls for ". . . substituting annual independent audits for mandatory, full scale examinations of every insurer." Much of his thesis is based on the belief that, "To examine (giant companies) which are firmly established as often as smaller, less sophisticated companies are examined, is an inefficient use of examination manpower."[2]

Texas has taken a partial step in this direction, in that the Code requirement for annual re-licensing of <u>all</u> companies was changed in 1955. A company's license to operate will now continue in force until revoked.[3]

A continuing problem is provision of adequate examiners--both in quality and quantity. In 1957, John Osorio, while serving a short term as Chairman of the Board of Insurance Commissioners, acknowledged the deficiency in examinations. He stated that during the fiscal year 1956-1957, the Board was

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[1]<u>Insurance Code</u>, Art. 1.15, Sec. 1.

[2]Robert A. Zelten, "Solvency Surveillance: The Problems and a Solution," <u>Journal of Risk and Insurance</u> 34 (December, 1972): 573,575.

[3]<u>Acts 1955</u>, 54th Legislature, p. 826, ch. 307.

able to make only 587 of the 1,504 examinations required by law. In spite of that, the Legislature was preparing to reduce the personnel allowed the Board. He asked for 140 examiners and 28 field actuaries, stating, "This Board cannot close down a company on rumor or conjecture or where the full facts are not thoroughly determined."[1] The Board was authorized 44 examiners, which is the present number.[2]

No matter how many examiners might actually be available, however, all problems would not be detected in time to forestall trouble. When a guaranty bill was being considered for the District of Columbia in 1971, the following testimony from Dr. Richard M. Heins was presented:

> Expansion and improvement in the quality of examination and audits of annual statements will curb insolvency. Still, crimes are committed regardless of the number of policemen hired, and insolvencies will occur regardless of the thoroughness or frequency of examination.[3]

A problem which has caused concern both in Oklahoma and Texas is the increase in "mail order" insurance. Oklahoma Commissioner Hunt has stated that he and his staff are giving close scrutiny to firms selling by this method: "We will continue to keep a very close eye on this type of operation to

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[1]Letter, John Osorio, Chairman, Board of Insurance Commissioners, to William S. Fly, Chairman, Senate Finance Committee, and Max C. Smith, Chairman, House Appropriations Committee, April 5, 1957.

[2]State Board of Insurance, Ninety-Eighth Annual Report.

[3]U. S., Congress, Senate, Committee on the District of Columbia, Hearing Before the Subcommittee on Business, Commerce and Judiciary, 1971, p. 140.

make sure that all of the facts are clearly and properly stated in the advertisement," he added.[1] Deputy Commissioner Grimes indicated that Pennsylvania is the source of most of the problems.[2]

The increase of such operations in Pennsylvania is understandable in view of their encouragement from former Commissioner Denenberg. In 1971 he stated he "intended to save the public at least $75 million a year by approving mail order sales of life insurance . . . ."[3]

The Texas Insurance Commissioner issued an Official Order in December, 1971, which attempted to forestall objectionable practices of mail-order business and deceptive advertising practices. Each company must file with its Annual Statement a certificate by an authorized officer stating that,

> . . . to the best of his knowledge, information and belief, the advertisements which were disseminated by the insurer during the preceding Statement year complied or were made to comply in all respects with the provisions of these guides.[4]

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[1]Southwestern Insurance Regional, July 31, 1973, p. 1.

[2]Interview, Oklahoma City, August 6, 1973.

[3]Robert B. Mitchell, "In Retrospect," The National Underwriter, Seventy-fifth Anniversary Edition, 1972, p. 221.

[4]Official Order, No. 35848, Commissioner of Insurance, State of Texas, December 21, 1971, "Commissioner's Guidelines in Respect of Insurance Trade Practices, Advertising and Solicitation.

Recent Legislation

Each session of the Texas Legislature considers many bills pertaining to insurance. In the 1973 session 29 such bills were passed, of which 15 pertained in some way to life insurance.[1] One of the most significant was the Life, Accident, Health and Hospital Service Insurance Guaranty Association Act.[2] In previous years such a proposal had been very controversial. In 1972, members of the Texas Life Convention (the larger companies) were generally opposed. At a meeting of a Legislative Interim Study Committee, Ben H. Carpenter, President of Southland Life, stated clearly the basis for their objection: "It is absolutely wrong to take funds away from the policyholders and stockholders of strong, prudently managed companies for the purpose of subsidizing mismanaged and fraudulently managed companies."[3] At the same meeting, Commissioner Cotten stated his views, and those of some of the smaller companies. He compared the Guaranty Fund to the Federal Deposit Insurance Corporation, which he said some bankers had probably opposed when it was initiated, but which he thought now had general support.[4]

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[1]List provided by Representative Bynum, "Insurance Bills Passed by the 63rd Legislature."

[2]Senate Bill 777, 63rd Legislature. It will add a new Article to the Insurance Code, Article 21.28-D. It applies only to legal reserve companies.

[3]Austin Insurance Report, February 29, 1972.

[4]Ibid.

By the time of the 1973 Legislature, support for some type of guaranty fund had increased. During testimony before the Senate Economic Development Committee, Board Chairman Christie referred to the bill as "social legislation." George Cowden, Speaking for the Texas Life Convention, agreed that it was "social legislation." He said that members of the Texas Life Convention favored the bill, although some had opposed it in the past.[1]

State Representative Ben Bynum explained to the writer how conflicting views had been reconciled to reach a compromise which would receive wide-spread support. First, no fund is actually created until a company fails. Then assessments are made based on total premiums in Texas. The amounts contributed may be shown on a company's financial statement as an asset, and then used as a tax credit against the premium tax over a period of five years. (In effect, this means the State is paying the amount out of its revenues, and spreading the losses among a larger group.) Second, no company may advertise in any way, nor print on the policy, that it is <u>insured</u> by the State.[2]

The attorney for the Texas Life Convention, Sam Winters, drafted most of the provisions in the bill which was finally passed (based on recommendations of the National Association of Insurance Commissioners). He stated some concern had been

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[1] <u>Ibid</u>., <u>Legislative Edition</u>, April 25, 1973.

[2] Interview, Amarillo, Jun 12, 1973.

expressed that a Guaranty Fund could lead to laxity in regulation because of less likelihood of loss to policyholders. He felt enough safeguards were in the bill to prevent that, however.[1]

Two important recent legislative acts have already been discussed: the Assets Protection Act of 1971[2] and the Surplus Investment Act of 1973.[3] The other act to be discussed here, the Insurance Holding Company System Regulatory Act of 1971,[4] is regarded as highly significant throughout the industry. Previous mention has been made of the trend toward holding company operation, in which a life insurance company is only one of the subsidiary components. Prior to this Act, Texas was without adequate regulatory authority to deal with some of the financial arrangements being consumated. The Act states (in part):

> It is further found and declared that the public interest and the interests of policyholders and shareholders are or may be adversely affected when: (1) control of an insurer is sought by persons who would use such control adversely to the interests of policyholders or shareholders . . . . [5]

The Commissioner is given authority over the payment of "extra-ordinary dividends" and certain transactions "between

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[1]Interview, Austin, June 20, 1973.

[2]Senate Bill 839, 62nd Legislature, 1971.

[3]Senate Bill 480, 63rd Legislature, 1973.

[4]Senate Bill 233, 62nd Legislature, 1971.

[5]Ibid.

a domestic insurer and any person in its holding company system . . . ."[1]

Representative Bynum said that if this bill had previously been in existence, it could have prevented the insolvency of one Texas company which had been bought by a "Mafia operation," and left as a shell without adequate assets.[2]

Types of Disciplinary Action Available to the Board

The Texas Insurance Code 1969 includes "Rules and Practice and Procedure Before the State Board of Insurance and the Commissioner of Insurance." The stated objective ". . . is to obtain a just, fair, equitable and impartial adjudication of the rights of parties in all matters within the jurisdiction of the State Board of Insurance and the Commissioner of Insurance." All official acts of the State Board and the Commissioner must be in writing and open to the public.[3]

When it becomes necessary for the Board to take action because of actual or threatened insolvency, three courses are open: receivership, conservatorship and supervision.[4] Commissioner Cotten stated that the Conservatorship is unique to

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[1] Ibid.

[2] Interview, Amarillo, June 12, 1973.

[3] Insurance Code, p. 516.

[4] Insurance Code, Arts. 21.28 and 21.28-A.

Texas.[1] Receivership comes through Court action, and the Code provides that the Liquidator designated by the Board shall be the receiver. He shall take possession of the assets, and,

> . . . subject to the direction of the Court, immediately proceed to conduct the business of the insurer, or to take such steps as may be necessary to conserve the assets and protect the rights of policyholders and claimants for the purpose of liquidating, rehabilitating, reinsuring, reorganizing or conserving the affairs of the insurer.[2]

The provision for the Liquidator, an employee of the State, to serve as receiver is regarded as an improvement in regulation.[3] Until 1961, liquidation employees were paid by the receivership. Their fees took precedence over claims of policyholders and creditors.[4]

Recognizing that once the process of receivership has been instituted, there is almost no possibility of returning to solvency, the Legislature has provided for ". . . the additional facility of supervision and conservatorship . . . for attempting the rehabilitation without immediate resort to the harsher remedy of receivership."[5]

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[1]Interview, Austin, June 20, 1973.

[2]<u>Insurance Code</u>, Art. 28, Sec. 2.

[3]Interview, John L. McCarty, Amarillo, June 6, 1973. Mr. McCarty was founder and President of Estate Life Insurance Company, which was placed in Receivership May 26, 1958. He stated that a great part of the Company's assets were used for expenses of the Receivership. See also p. 233.

[4]Clay Cotten, Interview, Austin, June 20, 1961; Code, Art. 21.28, Sec. 12A.

[5]<u>Insurance Code</u>, Art. 21.28-A, Sec. 1.

Supervision may be instituted when the Commissioner determines that a company is, or appears to be, insolvent, or has failed to comply with the law, or when the company gives its consent. From the time of notice of supervision, the company has sixty days to correct the situation. During supervision there are certain restrictions on the company's actions designed to protect its assets.[1]

If the conditions are corrected within the sixty days, supervision is discontinued; if not, the Commissioner shall immediately take charge of the Company as Conservator.[2] In this capacity he takes managerial authority to try to rehabilitate the company. Or, if he feels the company cannot be rehabilitated, he may make immediate application to a district court in Travis County, Texas, for leave to file suit to forfeit the company's charter.[3]

Commissioner Cotten stated that there were "twelve to sixteen small companies which were in and out of conservatorship all the time." Olympic Life (part of the Sharpstown State Bank scandal) was in conservatorship for two years, and one company had been under supervision for three years.[4]

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[1]Ibid., Sec. 4. See Appendix B for example of Supervision Order.

[2]See Appendices C, D, and E for examples of Conservatorship Orders.

[3]Insurance Code, Sec. 5.

[4]Interview, Austin, June 20, 1973. See also, p. 227 for comments of William Hunter McLean.

Procedures of this type have aided greatly in maintaining the values of a going concern, and in most cases--even if the company could not be rehabilitated--have resulted in reinsurance or transfer of the insurance without any loss to policyholders in the long run.

When a company has reached the stage of receivership, some losses are inevitable. Those persons whose claims are not satisfied, or whose equity is wiped out, will not approve of the arrangement. When critics call attention to the large number of failing companies in Texas in the past, proponents of the industry in the state refer to the large number of successful companies. The many types of small companies in Texas have made life insurance available to a great many people who might otherwise have had none available. The type of regulation in Texas has reflected the strong desire in the state to aid local business, and to place more reliance on competition to regulate the market than is found in some other states.

Chapter VI will discuss some of the conflicting purposes which serve as a guide to regulation, and point out which purposes have been dominant in Texas.

CHAPTER VI

CONFLICTING PURPOSES OF REGULATION

This study has examined the life insurance industry in the nation and in the State of Texas. It has also examined the regulatory system under which the industry functions. In Chapter III some of the characteristics which create a demand for regulation were considered. It was also pointed out that there are several types of demands which call for different types of regulation. These conflicting demands are analogous to the differing goals in our economy as a whole. Ostensibly, a desire to maintain competion is our primary goal, yet there are also other purposes to be served. In time of war, military considerations may be given priority; in time of depression, problems of unemployment may be considered paramount. At all times, the desire to protect the "little businessman" is much in evidence.

Just as pursuit of these goals may lead the economy in different directions, so the differing purposes to be served by the insurance industry will call for different regulatory actions. Some of these conflicting purposes will be examined here.

Economic Goals

It is easy for regulators, and the practicing politicians who have constructed the regulatory system, to say that they are acting in the "public interest" or the "common good." However, it is difficult to define public interest. Some, such as Joseph Schumpeter, deny that such a concept can even exist:

> There is, first, no such thing as a uniquely determined common good that all people could agree on or be made to agreee on by the force of rational argument. This is due not primarily to the fact that some people may want things other than the common good but to the much more fundamental fact that to different individuals and groups the common good is bound to mean different things.[1]

Any government intervention in the market--for however valid a purpose--will benefit some and harm others. Paul Samuelson said, "There are no rules concerning the proper role of government that can be established by *a priori* reasoning."[2]

In our economy continuing attempts are made to "improve" the market operation, but the government action is no guarantee of success. Professor James Hibdon has pointed out the difficulties which can arise:

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[1]Joseph A. Schumpeter, *Capitalism, Socialism and Democracy*, 3rd ed. (New York: Harper & Row, Harper Torchbooks, 1950), p. 251.

[2]Paul A. Samuelson, "The Economic Role of Private Activity," in *The Collected Scientific Papers of Paul A. Samuelson*, Joseph E. Stigley, ed., Vol. II (Cambridge: The M.I.T. Press, 1966), p. 1423.

> There can be little disagreement with the proposition that if the market economy does not provide satisfactory results and governmental direction of the economy will provide better results, then the latter should prevail. But if the proposition is unchallengeable, the conditions of its application are less obvious. It is not always demonstrably evident that the losses due to flaws in the market economy can be minimized by increased governmental control and direction.[1]

This paper has quoted Ralph Nader, whose views seem to be that the market must be regulated.[2] There are also those who say that the market must be left alone.[3] Most regulation is devised by those whose viewpoints lie between these two extremes. Spencer Kimball points out the influence of both of these viewpoints on insurance regulation:

> An accomodation between the two forces resulted in unevenness of regulation of different aspects of the business. Thus, there was continued reluctance to interfere in underwriting and other management decisions, except for very cogent reasons. On the other hand, investment was tightly controlled by the law.[4]

In most cases of government intervention in the market process the control of rates is of primary concern. This is

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[1]James E. Hibdon, "The Market, Externalities, and the State," in Money, the Market and the State; Economic Essays in Honor of James Muir Wallace, ed. by Nicholas A. Beadles and L. Aubrey, Jr., (Athens: University of Georgie Press, 1968), p. 159.

[2]p. 71.

[3]Among the many capable expressions of this viewpoint are the following: Henry C. Simons, "The Requisites for Free Competition," in Economic Policy for a Free Society (Chicago: University of Chicago Press, 1948); and Milton Friedman, Capitalism and Freedom (Chicago: University of Chicago Press, 1962), Chap. 1.

[4]Spencer L. Kimball, Insurance and Public Policy (Madison: University of Wisconsin Press, 1960), p. 308.

particularly true in the various modes of transportation and of those industries generally regarded as public utilities.[1] Such control is traditionally regarded as designed to protect the "public interest," but such a viewpoint is not universally accepted. Professor George Stigler advances the thesis that ". . . as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit." He further believes that the regulated industry favors price fixing, "Even the industry that has achieved entry control will often want price control administered by a body with coercive powers."[2]

Life insurance regulation in Texas does not encompass setting of rates, except in a very general way. The determination of minimum required reserves implies that rates must be adequate to maintain such reserves. However, a company has considerable leeway in determining its rate levels and its rate structure.[3]

[1]Clair Wilcox, op. cit. Other authorities include insurance in the public utility field, as, for example, "Included in this category were transportation facilities, warehouses, docks, ferries, insurance firms, markets and taverns," (Fite and Reese, op. cit., p. 146.)

[2]George J. Stigler, "The Theory of Economic Regulation," The Bell Journal of Economics and Management Science, 2 (Spring 1971): 5.

[3]A different process is followed in regulation of fire and casualty insurance. These rates must be approved by the State Board, although the 1973 Legislature made some changes in the process. House Bill 64, 63rd Legislature, 1973, authorized deviation from State Board approved rates when a deviation application is submitted to and approved by the State Board. This is regarded as one of the important bills of the 63rd Legislature.

Insurance companies in Texas are also subject to most of the restrictions and obligations of other types of corporations. The Code states, "The laws governing corporations in general shall apply to and govern insurance companies incorporated in this state insofar as the same are not inconsistent with any provisions of this Code . . . ."[1]

The State of Texas recognizes no more nor less obligation to protect investors in insurance companies than in other types of business activities, but any action taken to help assure a company's solvency will be of benefit to the stockholders. In contrast, California and New York have taken specific action to try to prevent" . . . speculation and overvaluation of the shares from the outset."[2] In California the minimum price for the initial offering of stock in a new life insurance company is $50 per share.[3] In New York the par value of life company shares cannot be less than $2.00.[4]

Solvency, or protection for policyholders, is almost universally regarded as a primary goal of regulation. Numerous

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[1] Insurance Code, Art. 2.18.

[2] William R. Robertson, speech, Williamsburg, Va., May 14, 1965, quoted in Jon S. Hanson and Duncan R. Farney, "New Life Insurance Companies: Their Promotion and Regulation," Marquette Law Review 49 (Fall 1965): 230.

[3] California Department of Insurance Memorandum, Nov. 25, 1964, as amended Jan. 15, 1965, quoted in Hanson and Farney, loc. cit., p. 230.

[4] 106th Annual Report of the Superintendent of Insurance to the New York Legislature Covering 1964, p. 25, quoted in Hanson and Farney, loc. cit., p. 230.

quotations in this paper have testified to this point, and will not be repeated here. Yet if solvency is regarded as the only goal or purpose, it will override others that have some validity. A pre-eminent concern for solvency might cause entry barriers to be set so high that new companies would have no chance to enter the market. Existing companies would then have an opportunity for monopoly profits.

Tibor Scitovsky addressed this point in a paper delivered at the 1949 American Economic Association:

> We think of competition as a force that tends to eliminate profits; and of monopoly or oligopoly power as something that restrains competition and thereby prevents the elimination of profits. Oligopoly power, therefore, is the power to restrain competition. Professor Chamberlin has shown that we must distinguish two kinds of restraint on competition. One of these is the obstacles to entry, which keep profits from attracting newcomers to a market and so prevent the elimination of profits by the additional competition of these newcomers. The other kind of restraint on competition is that imposed on the market behavior of established firms, which enables them to raise prices higher relatively to costs than they could in the absence of such restraints.[1]

Professor Donald Dewey has expressed the general aversion to monopoly in our nation (and thus the belief in "small" business) as follows: "Over the years the case against monopoly has rested mainly on the popular conviction that its posession confers on the fortunate party an unfair advantage in the competition for the good things of life."[2] The letters

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[1]Tibor Scitovsky, "Ignorance as a Source of Oligopoly Power," American Economic Review 40 (May 1959): 48.

[2]Donald Dewey, Monopoly In Economics and Law (Chicago: Rand McNally & Co., 1959), p. 1.

quoted in the previous chapter from presidents of several Texas life insurance companies bear out the belief that small companies should be allowed to grow. Some of the difficulties facing small companies are brought out clearly in a recent letter from the Commissioner of Insurance in Colorado, a former insurance agent, who has held office since 1964:

> Perhaps the greatest problem facing a small insurance company today is its size. They are finding it extremely difficult to compete with larger companies, both for getting agents to represent them and for selling of business. This is particularly true in the life and accident field.
>
> Evidence of this is rather clear in the increasing number of acquisitions and mergers that are going on. Repeatedly we hear in hearings relating to acquisitions that the small companies have not been able to grow, and therefore, consider merger as one means of getting large enough that they can compete.
>
> Related also to the size problem is the cost of doing business. Computer programs and other procedures cannot be justified unless the volume is sufficient. Combined, a small company finds their costs going up out of proportion to their volume, their volume not going up because of their size, and their size making it difficult for them to maintain a sales force. Finally, the insurance regulator looks at their high expenses of operation, their slowly depleting surplus, and has a great concern for the insuring public.[1]

A spokesman for small and medium-sized companies gives an illustration of the expense problem in this way:

> The big problem is the enormous increase in the items of general expense, which is a by-product of inflation and one wholly outside the control of the

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[1]J. Richard Barnes, C.L.U., Insurance Commissioner, Colorado, Letter to writer, July 11, 1974.

> industry. Some of it, I know, is occasioned by vanity; some small companies think that they need a computer of a size capable of serving American National, when all they need is a ten-key, eight-digit adding machine. But when you consider that the cost of mailing the premium notice of an older policy has increased more than 500 per cent, it is easy to get the problem in context.[1]

The Texas Insurance Code, Part II, includes portions of the Business and Commerce Code pertaining to Trusts and Monopolies. Included are definitions of trusts and monopopolies, and lists of certain prohibited acts which ". . . tend to prevent or lessen competition."[2] The numerous mergers of insurance companies without challenge under this Code indicate a clear feeling that competition is not thereby lessened.

An alternative view is that the approval of the mergers may indicate a favoring of large companies, as expressed in this letter from former State Insurance Board Chairman Hunter McLean:

> In many states, including Texas, there is a legislative and regulatory distrust of new or small companies that takes form in discriminatory statutes and regulations, and in their enforcement. With anti-trust and anti-monopoly suits being filed by the score against giant general corporations all over the country, it may be noteworthy that not a single giant life insurance company has been filed on by any state regulatory agency, even though some are enaged in the buying of business with large demand deposits in banks, mortgage loan take-out agreements with mortgage lenders, or what have you,

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[1]DeWitt H. Roberts, Executive Secretary National Association of Life Companies, (Atlanta, Ga.) Letter to writer, October 24, 1973.

[2]Insurance Code, Part II, p. 449-452. (This portion of the Insurance Code incorporates Secs. 15.01 and 15.02 of the Business and Commerce Code-Vernon's Annotated Texas Statutes.)

in exchange for credit or permanent life insurance origination.[1]

In a subsequent letter Mr. McLean outlined some of the conflicts that appear in insurance regulation:

> The original and paramount purpose of insurance regulation is solvency. In contradition of purpose, much legislation and political campaign demagoguery, compelling greater benefits for and lower costs to insureds, invites insolvency. Also, almost no recognition has been given the conflicts of prudence vs. speculation inherent in insurance. The insurance company official is charged with the duty of prudence to maintain solvency while, at the same time, being subjected to political criticism for not accepting speculative insurance risks. Bankers being charged solely with prudence, legislators would not consider for one minute a bill requiring them to make loans to replace the burned up automobile of any character that walked into the bank. Yet insurance officials are expected to accept substandard risks, in cases of workmens compensation are required to do so, and still measure up to the rule of prudence.[2]

Regulation of life insurance company investments may also be concerned with concentration of economic power in a way unrelated to normal regulatory procedure. Kimball and Denenberg state, "The laws may, for example, prohibit an insurer from purchasing a block of stock in another corporation large enough to permit the insurer to establish control."[3]

The possibilities of political influence on investment regulations are illustrated in this statement from Mr. McLean:

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[1]William Hunter McLean, Dallas, Letter to Don J. Willmon, October 4, 1973.

[2]William Hunter McLean, letter to writer, November 2, 1973.

[3]Kimball and Denenberg, op. cit., p. 127.

> Bank Stocks are favored by statute. Until the last session of the Texas legislature a life company could have had 100 per cent of its assets invested in the stock of any one bank . . . .[1]

There can also be influence on investments based on "social" objectives. Kimball and Denenberg give an example of this from New York:

> For example, in authorizing investments in housing, Sec. 84 of the New York Insurance Law states: "To promote and supplement public and private efforts to provide an adequate supply of decent, safe and sanitary dwelling accomodations for persons of low and moderate income and to assist in relieving the housing situation, any domestic life insurance company may, wherever it is actually doing the business of life insurance, acquire or construct housing projects . . . ." Social objectives like these are more numerous than they were--it is no longer possible, if it ever was, for the insurance industry to regard the great needs of our society as irrelevant to the insurance business, nor does the responsible leadership in the insurance community wish to do so.[2]

Social and Political Goals

On the national scene the "social responsibility" of the life insurance industry has been recognized and accepted. At a White House Conference called by President Lyndon Johnson in September, 1967, a group of 163 of the leading life companies pledged $1 billion to be made available immediately to finance housing and other job-creating activities in the city core areas.[3] By the spring of 1970, the Institute of Life

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[1]William Hunter McLean, Dallas, Letter to Don J. Willmon, October 4, 1973. The legislature changed the regulations to allow a company to invest ten per cent of its assets in any one bank or bank holding company. (Insurance Code, Art. 3.39, Part I, A. 12.)

[2]Kimball and Denenberg, op. cit., p. 128.

[3]Charles Moeller, Jr., "Economic Implications of the Life Insurance Industry's Investment Program in the Central City." Journal of Risk and Insurance 36 (March 1969): 97.

Insurance estimated that \$1.5 billion had been made available under this program, with \$1 billion going for housing, and that 54,000 jobs had been created in the process.[1] In the program each company made its own decisions and its own investments, taking into consideration both short-range and long-range responsibilities to its owners. Only on such a basis could the program be justified by the industry. Company officials felt that outside direction might jeopardize future business success.[2]

By 1973 this Urban Investment Program had reached a new goal--\$2 billion pledged to be diverted from usual investments into special higher-risk investments designed to benefit residents of inner core areas.[3]

In addition to "socially desirable" investments, there are also "politically desirable" investments. The previously-mentioned provision for investment in "Securities Authorized by Special Acts of the Legislature" is a case in point.[4]

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[1]Philip Zinkewicz, "Attention Must Be Paid--Life Industry Response to Social Problems," Weekly Underwriter, January 9, 1971, p. 46.

[2]Charles Moeller, Jr., loc. cit., p. 93.

[3]Life Insurance Fact Book 1973, p. 10.

[4]Insurance Code, Art. 3.39, Part I, A.16. Most of these specific items pertain to authorization to invest in bonds of Navigation Districts, Municipal Improvement Districts, and the like. Bonds of five of the sixty Water Supply and Control Districts authorized under General Law are authorized as investments for insurance companies. (Vernon's Annotated Texas Statutes, Secs. 8280-133, 8280-134, 8280-137, 8280-138 and 8380-139.)

Newspaper Editor Thomas Thompson explained how these special situations could be created:

> A Texas legislator with enough trading stamps occasionally can get a new class of investments authorized. For example: A Texas domestic life insurance company is specifically authorized to be able to invest its money in "any paving certificate issued by any city in the State of Texas and secured by first lien on real estate." Now isn't that a fine blue chip investment for a life insurance portfolio?[1]

Former Texas Commissioner Cotten described this process as the Legislature "continually chipping away" at the Board's authority.[2]

Revenue and Employment Goals

The Texas Legislature has also taken steps to encourage investment within the State by differential tax rates. The tax assessed against foreign companies for premiums collected in Texas (3.3 per cent) is higher than the premium tax on domestic companies (1.1 per cent). The former rate may be reduced to 3.02 per cent, 2.75 per cent, 2.2 per cent or 1.92 per cent, depending on the percentage of investments of "Texas Securities."[3]

Investment by insurance companies in the state creates employment, as does the selling and servicing of insurance. Of the one and one-half million people employed in insurance in the nation in 1972, approximately fifty-six per cent were

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[1]Thomas Thompson, Amarillo Globe-Times, April 19, 1972.

[2]Interview, Austin, June 20, 1973.

[3]Insurance Code, Part III; Vernon's Annotated Civil Statutes, Arts. 4769 and 7064a. "Texas Securities" are defined in Art. 3.34 of the Texas Insurance Code.

employed wholly or partially in life insurance. With about five per cent of all life insurance in the nation in Texas, probably a similar per cent of the employees would be in Texas.[1] If so, this would amount to more than 40,000 people in 1972. These people are working in a "smokeless industry" of the sort which most communities consider desirable. It is understandable that states would encourage the location of such industries within their borders.

State regulation might also be designed to attract companies because of the tax revenue. The figures listed in Chapter IV show this to be a substantial figure in Texas. Mr. Samuel C. Cantor, former Acting Superintendent for Insurance in New York, and now Senior Vice President for Law and External Affairs of the Mutual Life Insurance Company of New York, was questioned about such a motive:

> In regard to your question about whether "laxity" (in regulation) is a result of a conscious decision to create a climate where local companies might prosper, Mr. Cantor recognized that this might be a legitimate orientation. As a former insurance commissioner, he feels that the modus operandi should be: 1) to protect the policyholder, 2) to insure that companies remain solvent and 3) within those constraints, to create an environment where companies prosper because if a company--particularly a mutual company--thrives, the benefits redound to the policyholders. Also motivation in Texas could be to attract tax revenues. California, for example, has offered tax advantages for companies. He believes this is not a compromise, as long as protection of the policyholders remains primary.[1]

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[1]These figures are taken from the Life Insurance Fact Book 1973, pp. 23, 96, 97.

[2]Letter, Suzanne T. Turner, Press and Community Relations Specialist, MONY, to writer, March 26, 1974.

No one would advocate that the various purposes of regulation discussed above should supersede completely solvency and protection of policyholders. Yet the more consideration any of them receives, the less certain become the primary goals. Legislators and regulators should realize that pursuit of one goal may impinge on the pursuit of another. However, it must be realized that in each state the combination of goals pursued will ultimately be decided through the political process.

CHAPTER VII

CONCLUSIONS AND RECOMMENDATIONS

Among economists there are often differences of opinion. When political interests must be considered, such differences may well be amplified. As the previous chapter has illustrated, regulation of the life insurance industry is designed to serve purposes which are sometimes incompatible. The writer's conclusions and recommendations in this chapter are based on a balance of what he deems economically desirable and politically feasible. This balance must recognize not only political and economic factors, but also the various groups whose interests are involved. These include not only insurance buyers, but stockholders, agents, company officials, and all citizens of the regulating states.

Conclusions

The stated purpose of this study was to analyze the effect of administrative regulation on the Texas life insurance industry, and to determine whether microeconomic theory could be an effective tool of analysis. The importance of theory was recognized by Texas Insurance Board Member Durwood Manford, who stated, "No theory was validity unless it is practical; nothing is practical unless there is a theory."[1]

[1]Interview, Austin, June 21, 1973.

The writer believes that theory has provided a tool of analysis in examining the structure, behavior and performance of the industry, but sometime is has been only a crude tool. One explanation of this fact is that there are significant differences between the life insurance industry and other industries for which analytical techniques have been more fully developed.

In this presentation analysis of the structure of the industry has been conducted in the conventional manner. The most obvious structural characteristic of the industry in Texas--the number of companies--undoubtedly has been influenced by regulation. The low entry requirements have encouraged the organization of new companies, as has the provision for lower premium taxes on domestic companies. Despite the claims of some representatives of smaller companies that regulation discriminates against them the process of organizing such companies continues.

Although there seems to be no general agreement as to the minimum size necessary for profitable operations, the smaller companies are finding it increasingly difficult to operate profitably. This is confirmed both by company officials and regulatory personnel. Economies of scale may become more of a barrier to entry than statutory requirements.

The low initial capital requirements which existed in Texas for many years generated much criticism, yet many companies have grown and prospered after starting with the minimum allowable capital and surplus. Even the current requirements are among the lowest in the nation. A much more significant factor than the initial capital is the relation of the capital and surplus to the operations of the company.[1] According to Kimball, the initial capital provides security for policyholders while a company gets a start, but then there is a need for a fund which, with ". . . the reinsurance arrangements of the company, must be related to the size and other characteristics of the company's portfolio, though certainly not in any relationship that is easy to compute."[2]

Dean Kimball also described the way in which insurance regulators in several European countries meet this problem by prescribing capital requirements on an individual company basis.[3] He believes the number of companies in the United States is too large for this at the present time. Nevertheless, it is quite possible that the declining number of companies in Texas will make it possible to look at each company more carefully in the future. New legislation would be needed, however, to make specific requirements for each company, as is done in Delaware and Maine.[4] An approach which seems more realistic politically is the New Mexico approach, which has capital requirements scaled to the size and nature of a company's operations.[5] As this paper has indicated, there is considerable

[1]See p. 228 for comment about amount of premium income in relation to solvency.

[2]Spencer L. Kimball, "Sketches From A Comparative Study of American and European Insurance Regulation," Journal of Risk and Insurance 32 (June 1965): 204.

[3]Ibid., p. 204-5.

[4]See p. 137-8.

[5]Ibid.

difference of opinion as to what constitutes the proper capital structure for a life insurance company. The question is sure to receive continued attention in industry, regulatory and academic circles.[1]

In addition to amount of capital needed, economies of scale also play a part in the increasing number of affiliations between life companies and mutual funds. A related development is the rising number of holding companies in which life insurance is only one component. These activities reflect the desire of the life insurance companies to ". . . regain that portion of the consumer savings dollar that in recent years has gone into other forms of savings."[2] Such actions accentuate the problem of defining industry boundaries for economic analysis and regulatory purposes. Edward Chamberlin spoke of such a problem at the American Economic Association in 1949:

> "Industry" or "commodity" boundaries are a snare and a delusion--in the highest degree arbitrarily drawn, and wherever drawn, establishing false implications both as to competition of substitutes within their limits, with supposedly stops at their borders, and as to the possibility of ruling on the presence or absence of monopolistic forces, by the simple device of counting the number of producers included.[3]

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[1]The Oklahoma Insurance Department is now seeking to raise initial requirements to $400,000, and also to require existing companies to meet that figure. (Gerald Grimes, Deputy Commissioner, Telephone Interview, August 7, 1974.)

[2]Best's Insurance Report, Life/Health 1973, p. ix. ("Recent years' refers to years prior to World War II, according to a letter from Robert J. King, Staff Analyst, A. M. Best Co., July 26, 1974.)

[3]Edward H. Chamberlin, "Product Heterogeneity and Public Policy," American Economic Review 40 (May 1950): 86-87.

The process of counting firms and seeking to measure concentration in the industry by traditional methods is inexact for the life insurance industry. Scitovsky and others have attributed this difficulty to ignorance, or the "uninformed market." Professor Belth has applied such an analysis to insurance:

> Given the many dimensions of ignorance in transactions involving insurance (and the practices that substitute for overt price competition), it is perhaps apparent that the extent of the industry's departure from the ideal of perfect competition is not fully reflected by concentration ratios. The shortcomings of these ratios in this regard may well be greater in this major industry than in any other. Casting further light on the state of competition in the industry, however, is far from simple. A major problem is to devise a defensible method of determining effective price--a method that permits valid comparisons to be made.[1]

In considering the behavior of the industry, the analysis of market strategy is very important. Using Professor Stocking's definition of strategy as "the weapon of a firm operating in an imperfectly competitive market,"[2] it is clear that this weapon includes a highly differentiated product and definite price discrimination. Other indicators of behavior patterns which are sometimes used, such as collusion, price leadership, conscious parallelism and merger history, are not always pertinent to life insurance.[3]

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[1]Joseph M. Belth and W. David Maxwell, "The State of Competition in the Life Insurance Industry," Antitrust Bulletin 15 (Summer 1970): 220.

[2]See p. 47.

[3]These factors are listed in "Legal and Economic Issues in Competition and Monopoly," Brookings Research Report No. 2, The Brookings Institution, Washington, D.C., June 1962, p. 4.

One of the most serious behavior problems--and one not found in other industries--concerns cost determination and accounting. The accounting problems of the industry are of such nature that traditional accounting methods are not used. They do not reveal the true cost of the product either to the industry or to the customer. It is thus practically impossible to determine at what point on an average cost curve a firm is operating.

Part of the problem arises from the practice of treating all acquisition costs as an expense in the year incurred. An example of the misleading nature of accounts kept in such a manner is provided in the explanation accompanying the current "Fortune Directory of the Fifty Largest Life Insurance Companies."

> One figure among the totals does seem at first glance to be out of joint. The group's net gain from operations was up only 2.1 per cent--versus 56.9 per cent in 1972. Metropolitan was primarily responsible for this sharp fall-off. The Met reported a net loss from operations of $13 million, versus a gain of $72 million in 1972. Such figures are deceptive, however. State insurance laws require a company to set aside reserves for the policies it writes; in addition it must charge off the cost of writing them as they occur. Thus that "loss," which is recoverable in future years, resulted from the fact that the company did a healthy volume of group and individual annuity business.[1]

Another part of the problem arises from the differing purposes to be served by the company's reports. One professor of business administration analyzed it in this way:

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[1]"The Fortune Directory of the Fifty Largest Life Insurance Companies," <u>Fortune</u>, July, 1974, pp. 112-113.

> Certainly in the life insurance industry the accounting methods prescribed for reporting to regulatory authorities are not suitable for reporting to investors. The Insurance Commissioner is primarily concerned with seeing that the policyholder is protected by the maintenance of unquestionable company solvency. The investor is primarily concerned with knowing the results of the company's operations. Reports prepared for distribution to stockholders and the investment community should reflect accurately the income resulting from company operations.[1]

A manual prepared to assist students and company officers seeking specific guides and principles for the completion of the required Convention form of annual statements acknowledges that there are many interpretations of the various items. The manual further reveals the inexact nature of the various accounts:

> Because of the long term nature of the life insurance contracts and the necessity of providing for reserves estimated to cover future guaranteed commitments, it would not be appropriate to imply that a given "profit" or "loss" is sustained by a company in any particular year. However, the Net Gain from Operations . . . is the company's expected results if future experience corresponds with the mortality and interest factors assumed.[2]

These problems of accounting are a contributing factor in the difficulty of explaining pricing policies of the industry. The difficulty is intensified by the failure of consumers to treat price as a prime factor in their consideration of life insurance. A review of significant events in

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[1]Reynolds Griffith, "A Note on Life Insurance Accounting," Journal of Risk and Insurance 31 (July 1964): 207.

[2]Charles M. Beardsley, Life Company Annual Statement Handbook (Winston-Salem, N.C.: Charles M. Beardsley, 1962), p. I-1.

the industry in the last quarter-century brought this comment on price-consciousness from the former editor of the Life and Health Insurance Edition of The National Underwriter:

> . . . people continued to buy life insurance in very much the same way they bought automobiles, groceries, booze, or legal and medical advice. They didn't ignore price, but neither did they try very hard to make sure they were dealing with the lowest bidder.[1]

Lack of attention to the price of the policy is also motivated by the belief that buying life insurance involves more than just the policy. It involves service from the agent and the company. The Press and Community Relations Specialist for Mutual Life Insurance Company of New York expressed this position:

> Denenberg and Senator Hart have been pushing in the direction of complete disclosure and standardization with certain minimal requirements for policy benefits. These are certainly paths that result from the consumer movement where people are concerned with getting the best value for their money. The other side is that freedom to provide a diversity of products and benefits is the ultimate direction of competition where management discretion and expertise, experience and new ideas works to the advantage of the consumer . . . . MONY and many of the other big companies say that professional service is one of the most important parts of life insurance because it is the only way to help the client find the right product for his own specific needs.[2]

Finding the right product in the midst of the plethora of policies may involve very high information costs. Critics

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[1]Robert M. Mitchell, "In Retrospect, The Last Quarter-Century in American Insurance," The National Underwriter, Seventy-fifth Anniversary Edition, 1972, p. 20.

[2]Letter, Suzanne T. Turner, New York, March 26, 1974.

of the industry believe costs could be lowered by required standardization of policies. Such a criticism is not unique to the life insurance industry, but is prevalent throughout the economy. A forceful answer to this criticism is given in the following passage from a well-known text:

> Some people think that most product differentiation is silly. Are Chesterfields not the same as Lucky Strikes; Cokes the same as Pepsis and Palmolive the same as Lux? Although the physical differences may be trivial, in the minds of some customers, they are significant . . . . You could declare them prejudiced, ignorant, or discriminatory, but all you mean is that their tastes or preferences differ from yours. And this should give us reason to pause before confidently asserting that buyers who discriminate among brands of cigarettes, aspirin, paper tissues, soap, corn flakes or canned milk do so only because they are irrational or uninformed.[1]

Some critics of the industry would meet the problem of alleged consumer ignorance by forced standardization. Professor Belth has recognized such a possibility, and considers it highly undesirable:

> A possible alternative to a rigorous system of information disclosure . . . would be the standardization of life insurance policies and a drastic reduction in the number of policy types. In my opinion, only two policy types would be needed: straight life and either one-year renewable term or five-year renewable term. The difficulty with the approach is that it would tend to place the life insurance industry in a straitjacket. Furthermore, I have more faith in the ability of consumers

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[1]Armen A. Alchian and William R. Allen, <u>University Economics</u>, 2d ed. (Wadsworth, California: Belmont Publishing Company, 1967), p. 118.

> to make decisions for themselves than in the ability of regulators to make decisions for consumers.[1]

The writer agrees with those who defend product differentiation. Consumer taste is one of the basic factors affecting demand, and the tastes of individual consumers differ widely. The market provides a mechanism for eliminating types of policies which do not satisfy consumer demand.

For the market to function in this way, however, more information is certainly needed by consumers. In testimony before Senator Hart's Subcommittee, Professor Belth stated that the major problem in the industry, as far as consumers are concerned, ". . . is the lack of good, solid, reliable information at the point of sale concerning the benefits and prices of the insurance they are proposing to buy."[2]

The difficulty of ascertaining these benefits and prices has been set forth at length in this paper. There has not yet been devised a simple system of price comparison. The system which Professor Belth proposed to the Subcommittee on Antitrust and Monopoly would involve:

> First, a two-page form that contains prescribed information to be given to the policyholder at or prior to the delivery of the policy; and second, the premium notice that the policyholder receives on each yearly anniversary of his policy.

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[1]Testimony of Joseph M. Belth. U. S. Congress, Senate, Committee on the Judiciary, The Life Insurance Industry, Part 1, Hearings Before the Subcommittee on Antitrust and Monopoly. 93d Cong., 1st Sess., 1973, p. 531.

[2]*Ibid*., p. 536.

> The first page of the two-page form would contain annual information about the policy, and the second page would contain summary information. The yearly premium notice would contain information in addition to that which companies provide routinely."[1]

For the consumer who seeks to compare prices of insurance policies in the same way he compares prices of automobiles or stereo sets, the above process seem unduly complicated. Yet it may be the price he has to pay if he continues to demand the differentiation which the market now provides.

Even an attempt to rank companies by the price of the policy (without using exact figures) is not a satisfactory solution. Professor Belth was asked if it were possible for Company A to rank higher than Company B on one type of policy, but lower than Company B on another. He replied:

> Yes; very definitely. As a matter of fact, this is one of the very serious problems, even with my book, because it only contains the information for certain policies
>
> And there is a big caveat in there that the figures pertain only to the policies shown, so that this, or Commissioner Denenberg's Shoppers' Guides have had very interesting impact on the industry. They are merely based on certain policies.
>
> Any kind of listing has got to be out of date the minute it's published; in fact, it's out of date even prior to the publication date and furthermore applies only to the policies shown.
>
> That is why the whole idea of shoppers' guides or listings or consumers' handbooks, or anything like that is not an adequate substitute for a full system of information disclosure at the point of sale.[2]

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[1] *Ibid.*, pp. 530-531.

[2] *Ibid.*, p. 539.

Even a simplified system of price disclosure would not satisfy the type of criticisms leveled at the industry by Ralph Nader.[1] While it seems to the writer that some of Mr. Nader's own criticisms fall within his characterization of "collateral irrelevance and semantic nullities,"[2] some of them indicate a view of life insurance which varies considerably from that of the industry.

He criticizes the industry because it "fails to sufficiently protect widows," while the industry cites with approbation the number of widows who are beneficiaries of life insurance policies. Nader says husbands are duped into buying too much of the wrong kind of insurance. Similar criticisms could be leveled at the way many consumer expenditures are made.[3]

The writer does not have information relating to Mr. Nader's charge that the Securities and Exchange Commission has blocked accounting reforms that would put life insurance profit reports on equal footing with those of other industries.

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[1]See pp. 71-72.

[2]Ibid. For example, he criticizes the industry for high expenses, "virtually all borne by the consumer." Yet ultimately all expenses must be paid by the consumer.

[3]For example, a decade ago much criticism of expenditures on funerals was spawned by Jessica Mitford's The American Way of Death (New York: Simon & Schuster, 1963). The answer of the funeral industry was that the American people made their decisions about money spent on funerals in the same way they made their decisions about other expenditures. (This statement is based on conversations with William N. Griggs, funeral director, Amarillo, over a period of several years.)

The evidence available, however, indicates the difficulties are inherent in the process, and not the result of deliberate obstruction.

In regard to the charge of a military-insurance interlock at the Veterans Administration and Department of Defense, Senator Hart's Subcommittee received testimony on this matter, but the question is outside the scope of this study.

Mr. Nader's charge that the industry's "quiet" concentration of economic power has been ignored by Congress is subject to considerable value judgement. As indicated in Chapter II, the concentration within the industry is not quite at the level which would call for antitrust action in an unregulated industry. The industry is close to such a level, however, and perhaps more study is needed of the inter-locking directorates of insurance companies, banks and other financial institutions.

The charge of lack of effective price competition is also subject to varying interpretations. The presence of a large number of companies would normally be expected to provide the sort of competition that would remove any monopoly profit from the price. Yet the industry is still criticized for high prices. Mr. Nader referred to the cost of distribution as "a national disgrace," and cites high agent turnover as a contributing factor.[1]

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[1]Hearings, loc. cit., p. 9.

The industry is aware of this criticism, and of its very real factual basis, but has not yet found the answer to the problem. Similar criticism came from an industry spokesman, Michael P. Walsh, Director of Marketing, Home Life of New York, who submitted a statement to the Senate Subcommittee. He acknowledged the lack of an "effective and efficient method of distribution," and called for the industry". . . to go from an institution which sells its products to a business which markets its products."[1] Mr Walsh also recognized that, "A competitive market depends on knowledgeable buyers."[2]

As such voices become more prominent within the industry, the likelihood of devising a more efficient distribution system increases. The industry has not survived for almost two centuries by being impervious to change.

Regardless of the type of distribution system, the elements determining cost will remain the same--mortality, investment income and operating expenses. Unless costs of distribution can be substantially reduced, operating costs will remain about the same. The presence or absence of regulation will have little effect on these costs, although it must be remembered that costs of comparable products vary widely among companies.

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[1]Ibid., p. 37.

[2]Ibid., p. 41.

The writer shares the belief, expressed to him by E. Jay O'Keefe, President of Western National Life of Amarillo, that the firms which have been successful under regulation in Texas would be successful in a free market. The companies would face the same costs, and would price their products in about the same way. (He describes his company has having a "gut low" price on ordinary life insurance.)[1] If regulation were to involve rate-fixing, then some high-cost firms might be driven from the market.

One problem which regulation has not been able to overcome completely is dishonesty and fraud. This is true in insurance, banking and other types of activities where integrity is an important factor. The McKinsey and Company study mentioned in Chapter I attributed seventy-seven per cent of <u>all</u> life company insolvencies to dishonesty.[2] A recent letter from former Texas State Board Chairman McLean describes the problem in the following colorful language:

> Insurance commissioners long for, but none have been so wise as to develop a "Wasserman Test" disclosing tendencies that may be present in individuals toward incompetence or dishonesty. Short of that, incompetence and dishonesty will continue to take their toll in life companies as well as in banks and other financial institutions.[3]

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[1]Interview, Amarillo, May 17, 1974: This low price also means low cash value.

[2]See p. 15.

[3]Letter, William Hunter McLean, Fort Worth, to writer, August 8, 1974.

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[1]Interview, Amarillo, May 17, 1974: This low price also means low cash value.

[2]See p. 15.

[3]Letter, William Hunter McLean, Fort Worth, to writer, August 8, 1974.

Mr. McLean also referred to the previously-reported study of comparative cost of losses in banks and life insurance companies.[1] He stated, "In proper perspective, the aggregate of policyholder losses from failure of life companies . . . as compared to banks, is as mice nibbling at the toes of elephants."[2]

Even in the absence of fraud, however, no regulation can prevent all the problems which might arise. Former New York Superintendent of Insurance Richard E. Stewart acknowledged such a problem:

> Sometimes we have indulged ourselves in the view that solvency--that is, the absence of failures of insurance companies--was entirely dependent on the quality of regulation . . . . All we can do realistically is to require adequate capitalization, guard against management activities that threaten financial condition of the company, and try to detect deterioration quickly and help in its repair. . . . But it is our responsibility to accept fully the fact that all these steps will sometimes not be enough.[3]

The writer believes that the absence of regulation would not precipitate drastic changes in the industry, either on the micro or macro level. There might well be changes in investment patterns, although these would come slowly because of the long-range nature of much life insurance investment.

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[1]See p. 108n.

[2]McLean, Letter, August 8, 1974.

[3]Richard E. Stewart, "The Social Responsibility of Insurance Regulation," in Insurance, Government and Social Policy, Spencer L. Kimball and Herbert S. Denenberg, eds. (Homewood, Ill.: Richard D. Irwin, Inc., 1969), pp. 37-38.

A study by the Research Department of the Federal Reserve Bank of St. Louis revealed:

> Despite considerable legal and traditional constraints, life insurance companies maintain one of the most diversified portfolios of the financial institutions. Compared with most of the other institutions, variations in the portfolio have been due to secular rather than cyclical forces. Recently, however, life insurance companies have exhibited increased vulnerability to cyclical influences.[1]

In very recent years these cyclical influences have involved changes in interest rates. The above study further reported:

> Of the methods by which life insurance companies might best meet their expanding competitition, investment in the stocks of private corporations appears to be the most promising. Since yields on certain stocks are potentially much higher than alternative uses of funds. it is not surprising that the companies have recently decided to organize their own mutual funds for stock investment purposes.[2]

The absence of regulations concerning investments might well change the approach of some companies, as explained in this statement from Hunter McLean:

> An offering of municipal bonds recently crossed my desk from a district in Harris County, Texas. These were general obligation water and sewer revenue bonds of a district contiguous with a subdivision development of 357 acres of land. There were six residents in the area and the vote for the bond issue was six to zero. The amount of the bond issue was over $2 million. Those trashy bonds are legal investments for life companies. The statutes encourage life

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[1]Roger W. Spencer and Michael J. Heppen, "Impact of Changing Economic Conditions on Life Insurance Companies," Working Paper No. 9, Research Department, Federal Reserve Bank of St. Louis, March, 1969, p. 6.

[2]*Ibid*., p. 11.

> company financing of such speculative ventures by others, at a higher development cost and risk, but deny a direct life company involvement in such developments even at a lower risk.[1]

Mr. McLean's letter illustrates what seems to the writer to be one of the major deficiencies of the Texas Insurance Code in relation to investments. The Code is concerned more with the form of the investment rather than the content or the risk involved. Other types of evaluations, such as the Moody bond ratings, could give the companies more opportunities for profit, yet still protect the policyholders as well as or better than they are now.

Analysis of investment practices is a part of the overall performance evaluation of the industry. In considering performance indicators for the industry, any criteria used are inexact because of lack of standards for measurement. It is clear, for example, that the industry presents a wide range of choices to consumers, though some critics say this variety of products constitutes a waste of resources. Does the industry provide innovations in its products to meet changing conditions and needs? The answer is equivocal. There are constant attempts at innovation, but the inertia of regulation may cause delays. Michael Walsh, whose testimony before the Hart Subcommittee was quoted above,[2] called for ". . . listening to the consumer and moving in the direction

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[1]Letter, William Hunter McLean, to Don J. Willmon, Dallas, October 4, 1973.

[2]See p. 218.

of supplyin' the products which he is demanding in the marketplace.[1]

One of the most challenging problems to the innovative ability of the industry at this time is the sale of a fixed dollar product in a period of inflation. The portion of disposable personal income going into life insurance premiums and annuity considerations has shown remarkable stability--fairly close to four per cent--for the last twenty-five years. The percentage of ordinary life in relation to term and group insurance has declined, however, and the latter are much less profitable to the company. The changing proportions for selected years are shown in Table VI-1.

TABLE VI-1

PROPORTIONS OF PERMANENT AND TERM INSURANCE
(per cent of total amount for years shown)

In Force	1950	1962	1970		
Ordinary - Permanent	88%	76%	72%		
Ordinary - Term	12	24	28		
Purchases	**1956**	**1962**	**1965**	**1967**	**1972**
Ordinary - Permanent	67%	61%	59%	59%	59%
Ordinary - Term	33	39	41	41	41

Source: Surveys by Institute of Life Insurance and Life Insurance Marketing and Research Association. (Reported to writer by Barbara Felicia of the Institute of Life Insurance of New York, July, 1974.)

[1] Michael P. Walsh, loc. cit., p. 41.

[2] Life Insurance Fact Book 1973, p. 11.

A Staff Analyst for the A. M. Best Company has pointed out the actions taken by the industry in the face of a growing percentage of less profitable sales:

> To make up for the lost "cash value" sales, companies have tried (not always successfully) to tie in mutual funds as a combination package thereby subscribing to the Wall Street theory of "Buy term and invest the difference."[1]

The industry has also sought to increase the marketing of its own equity products, such as variable annuities and variable life insurance, but little headway has been made.[2] This delay is due partly to lack of knowledge of the product and partly to regulatory inertia.

The MAP Report (Monitoring Attitudes of the Public), 1973 Survey, included questions about these products, and revealed little knowledge of either:

> So far, scarcely anyone knows what the business's relatively new variable annuity product is. And of the few who say they know, only about one in three (representing two per cent of the total population) is able to give a correct description. This is not surprising, when it is recalled that most people are poorly informed about life insurance itself.[3]
>
> Even fewer people than in the instance of variable annuities know what variable life insurance is (four per cent). Again, of those who say they know,

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[1]Robert J. King, Staff Analyst, Life/Health Dept., A. M. Best Co., Morristown, N. J. Letter to writer, July 26, 1974.

[2]John W. Popp, "Past, Present, Future of Life Insurance: Part XV of a Series," The National Underwriter, October 3, 1970, p. 86.

[3]The MAP Report (New York: Institute of Life Insurance, 1973), p. 86.

> only about one in three is able to give a correct description. In other words, at the present time a few more than one million adults know what variable life insurance is.[1]

For companies seeking to develop new products to combat inflation, any delay is frustrating. Hunter McLean places the blame on regulatory officials.

> The advent of the variable or equity life policy exposes the inertia of regulation to innovation as well as the ineptness of Federal regulation of insurance. In the last ten years, while inflation was eroding the cash values and face amount of everyone's life insurance protection, life companies have pursued the issuance of variable or equitable life policies only to be frustrated at every turn, to a lesser degree by state regulators than by the Securities and Exchange Commission which, to this date, has yet to issue definitive regulations.[2]

Lack of product knowledge and delay in regulatory action are mutually reinforcing. There is much inertia in the regulatory process, and without strong popular support for a major change, the change will be slow to take place. In almost any type of administrative procedure, maintenance of the status quo is the path of least resistance.

Such delay is more understandable in light of two points brought out earlier in this paper; insurance regulation is different from that found in other industries, and the consumer lacks knowledge of the product. In the absence of rate regulation, the consumer is not as aware of the existence of regulation as he is in the case of some other industries

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[1] _Ibid._, p. 88.

[2] William Hunter McLean, Letter to Don J. Willmon, Dallas, October 4, 1973.

And lacking knowledge of the product, he relies on the agent or the reputation of the company. He will not initiate a demand to regulatory authorities for action on some new product when he does not even know what the new product is--or realize a need for one.

The above comments have related primarily to company operations, but the writer has arrived at some additional conclusions about the Texas regulatory system. One of the greatest strengths is the provision for Supervision and Conservatorship. These actions can be taken before serious trouble develops, with the possibility of preventing irrevocable damage. The value of such provisions is indicated by current action of the Oklahoma Insurance Department in seeking legislative authorization for similar powers.[1]

There has been little loss to policyholders when a life insurance company in Texas was placed in receivership, because the Commissioner has arranged for other companies to assume policy obligations. In the future, the Guaranty Fund will give policyholders additional protection.[2] But there has always been loss to stockholders, creditors and employees. Supervision and Conservatorship are designed to prevent these losses. Former Texas Insurance Commissioner Cotten spoke of a few small companies which were "in and out of conservatorship

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[1]Gerald Grimes, Deputy Commissioner, Oklahoma Insurance Department, Telephone Interview, August 7, 1974.

[2]See pp. 183-4.

all the time."[1] Former Texas Board Chairman McLean was asked to comment about the significance of such a situation, and replied:

> I believe Mr. Cotten's statement . . . was casually made. Texas has a law permitting removal of incompetent management and if the situation was as stated, the Commissioner would have been negligent in not removing management. And, commissioners do try to save weak companies by giving them time to seek merger or reinsurance with strong companies. An agency force and an insurance account are non-statement assets of great value and may only be preserved for benefit of policyholders by avoiding receivership.[2]

In the final analysis, the instituion of either of these provisions is a matter of judgement, as is their termination. The results in the Girard Life case[3] justified a lengthy period of search for proper disposition of the company. Undoubtedly the benefit of hind-sight shows that some companies should have been placed in receivership at an earlier stage.

The efforts to keep a company in operation in Texas are a proper accompaniment to ease of entry. There would be considerable waste of resources--as there has been at times in the past--in allowing companies to begin operation, only to fail shortly thereafter. The ease of entry and the rather liberal approval of a wide variety of policy forms have not

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[1]See p. 188.

[2]Letter, William Hunter McLean, Fort Worth, August 8, 1974.

[3]See pp. 177-8.

enabled the Texas companies to dominate the market, however. As indicated in Chapter IV, Texas companies have about fifty per cent as much insurance in force in Texas as foreign companies have in the State. The proportion of new insurance sold by the Texas companies is greater than that, however.[1]

There must be a variety of reasons for the large percentage of insurance in out-of-state companies. Undoubtedly many of the people who have moved into the State since World War II have continued their insurance with companies active in their former locations. Economies of scale are important, too. National advertising is a factor, but the ability to recruit and train an agency force is probably more significant. As brought out by the Colorado Insurance Commissioner, operations are becoming increasingly difficult for the small company.[2] His view was corroborated by the McKinsey and Company survey which reported, "Almost eighty per cent of the insolvent companies had less than $1 million premium (annually). . . . Further, in nearly seventy per cent of the insolvent companies, the owners had been in control for less than five years . . . ."[3]

The increased recognition of such difficulties may well intensify a demand for larger initial capital and surplus

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[1]See pp. 122-3.

[2]See p. 196.

[3]McKinsey and Company, Report to National Association of Insurance Commissioners, April, 1974. Quoted in Letter, William Hunter McLean, August 8, 1974.

requirements. The writer feels that the capital structure should be related to operations, and that size, per se, does not provide strength.

Recommendations

The very extensive problems of the life insurance industry which are outlined in this study cannot be resolved in a short period of time. But progress toward solution can be initiated, and in other areas progress already underway can be accelerated. The writer believes the following areas offer the greatest possibilities for improvement, and the greatest probability of effective action.

There is no question but that regulation should continue. The characteristics which placed the industry under regulation continue to be significant. In the discussion of federal versus state regulation, the writer favors continued state regulation. In the face of very wide-spread opposition to federal control--both in the industry and among state agency personnel--the transfer of control would be difficult both administratively and politically. There is considerable variation in regulation among the states, but the industry has learned to adapt to it. Even though the quality of regulation in some states is poor, there is no assurance that federal control would be better.

The National Association of Insurance Commissioners provides a forum for discussion of problems, and a mechanism for achieving standardization where necessary. The recently completed study of early warning tests is an outstanding example. Building on the experience of states such as Texas, Illinois, and California, which had been using such tests, the lessons from each one could be drawn upon to achieve a solution helpful to all.

Such a process shows the strength of the federal system. It is possible to approach a common problem in a number of different ways at the same time. Justice Brandeis, in his dissenting opinion in New State Ice Co. v. Liebmann,[1] stated clearly the advantages of such a system:

> There must be power in the states and the nation to remould through experimentation, our economic practices and institutions to meet changing social and economic needs . . . .
>
> To stay experimentation in things social and economic is a grave responsibility. Denial of the right to experiment may be fraught with serious consequences to the nation. It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country. This Court has the power to prevent an experiment. We may strike down the statute that embodys it on the ground that, in our opinion, the measure is arbitrary, capricious or unreasonable . . . . But in the exercise of this high power, we must be ever on guard, lest we erect our prejudices into legal principles. If we would guide by the light of reason, we must let our minds be bold.[2]

These advantages of a federal system will be lost, however, unless there is a mechanism for transmitting valu-

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[1] New State Ice Co. v. Liebmann, 285 U.S. 262 (1932).

[2] 285 U.S. 262, 311.

able new ideas throughout the system. The National Association of Insurance Commissioners, and the various industry-wide trade associations provide such a mechanism.

From an overall regulatory standpoint, there must be increasing efforts through the political process to define the goals of insurance regulation. Dean Kimball writes of separating goals and of means of reaching those goals.

> It may be that we can readily sacrifice some intermediate goals that are in fact only means, in order to achieve more nearly the great fundamental purposes that we seek, and on which most of us would probably agree.[1]

We know, for example, that we cannot create morals and integrity through legislation, yet we know they are indispensable in the regulatory process. As expressed by Dallas newspaper editor Dick West, "We must have knowledgeable as well as honest public officials. We must have leaders with vigor, drive, vision, and expertise."[2] With such officials, of course, almost any regulatory system could be made to function satisfactorily. Since some regulatory personnel fall short of this goal, the system itself becomes important.

The regulation we have now in Texas is viewed in different ways. It is criticized as too loose by representatives of some of the large Eastern companies, and as too rigid

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[1]Spencer L. Kimball, "The Goals of Insurance Laws: Means versus Ends," Journal of Risk and Insurance 29 (March 1962): 29.

[2]Dick West, Dallas Morning News: Quoted in letter from Don J. Willmon, June 13, 1972.

by some of the smaller Texas companies. Board Member Manford said Texas was the only state carrying out the provisions of the McCarran-Ferguson Act.[1]

The government of Texas has been largely under the control of conservatives for the last forty years, and "big business" has wielded considerable influence--big banks, big insurance companies, big contractors. The present Governor is a wealthy rancer, yet the Chairman of the State Board of Insurance whom he appointed is regarded as being "consumerist" oriented. Chairman Christie has sought the viewpoint of all elements of the industry. The continuation of this process of inquiry and study by the State Board of Insurance is strongly recommended.

Since Texas was one of the first states to see the advantages of the early-warning tests, the revised procedures will, no doubt, be eagerly adopted. Wide-spread use of these tests will be of great help to regulators in all states, and their use is strongly recommended.

Similar approaches must be made in the field of accounting, and in the whole process of company examination. At a time when the accounting profession is reexamining many of its traditional tenets, it is appropriate for qualified members of the industry and the profession to work together to devise more exact ways of representing the financial position of individual firms.

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[1]Interview, Austin, June 21, 1973.

Some states suffer, as Texas has in the past, from an inadequate staff of examiners, both in quality and quantity. This situation can be improved. From a political standpoint, the companies must be convinced that proper examination is to their benefit. Then they will use their influence to secure more adequate funding for the examination process.[1] Some of the efforts of consumer groups could well be directed into this channel.

The National Association of Insurance Commissioners recognizes the personnel problem, and is considering a sort of "blood bank" of certified insurance examiners who can be hired by states without adequate training and funding facilities of their own.[2] There is no reason why such examiners should not have the training and prestige of bank examiners. Adequate compensation would make it possible to secure and maintain the caliber of personnel needed.[3]

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[1]The Austin Insurance Report of February 29, 1972, reported a remark of State Senator Murray Watson to President Ben H. Carpenter of Southland Life at a legislative committee hearing concerning the idea of a Guaranty Fund. He said he had never seen Carpenter present to testify before the legislative committees in favor of increased appropriations for the Insurance Board, and hoped he would in the future.

[2]Letter, Suzanne T. Turner, March 26, 1974.

[3]When the former Estate Life Insurance Company of Amarillo was placed in receivership, newspaper accounts of the Hearing before the Insurance Commissioner gave prominent mention of an alleged "gift" of $2,000 by the President of the Company to the State Examiner assigned to his company "who was in financial distress because of illness in his family." (Amarillo Globe-Times, December 19, 1957, p. 1.)

Much regulatory attention in recent months has been devoted to price disclosure, as shown by the testimony before Senator Hart's Subcommittee, and the Orders in Arkansas and Texas for use of the Interest-Adjusted Cost Comparison Index. Yet the evidence presented in this paper shows that price is not a prime concern of consumers.

Professor Belth, who has studied the matter of insurance costs and cost disclosure extensively, favors much more through disclosure. He recognizes the difficulties involved, which he attributes to ignorance on the part of buyers and agents, complexity of the product, and apathy on the part of buyers.[1] Despite these difficulties, he urges the industry to procede to implement a thorough disclosure system, although on a "gradual basis" because of the significant impact.[2]

Cost comparison and price disclosure are really parts of the same problem--how to enable the consumer to make intelligent decisions in the market place. The industry must take cognizance of the desire for more information, and cooperate in finding ways to make this information more meaningful and readily available. The writer believes, based largely on conversation with E. Jay O'Keefe, President and former Actuary

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[1] The Life Insurance Industry, Hearings, loc. cit., p. 526.

[2] Joseph M. Belth, The Retail Price Structure in American Life Insurance (Bloomington: Bureau of Business Research, Graduate School of Business, Indiana University, 1966), pp. 239-246.

of Western National Life of Amarillo,[1] that the interest-adjusted method of cost comparison[2] is not satisfactory for the purposes intended. It is an attempt to adjust the cost of insurance for the time-value of money (interest), but the method is unable to account adequately for the various combinations of premium and cash value. Nor is it able to account for the differences in costs involved in cancelling a policy within a few years and in holding it till death.

The search for satisfactory methods of cost comparison must continue, however, along with increased emphasis on consumer education concerning the complexities of life insurance.[3]

Perhaps it is premature to require cost comparison and disclosure before product classifications are more standardized. Some standardization is desirable, but beyond some point it will encroach on what is described in the letter from the MONY representative as ". . . the freedom to provide a diversity of products and benefits."[4] Regulators must examine

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[1]Interview, Amarillo, February 12, 1974.

[2]See p. 59.

[3]Appendix F reproduces a part of Professor Belth's statement before the Subcommittee on Antitrust and Monopoly explaining the "package" nature of premiums on ordinary life insurance. Much of the controversy about price disclosure centers around this concept. The industry largely favors one price for the "package" of savings and protection, while representatives of consumer movements advocate pricing each part separately.

[4]See p. 212.

carefully the line they draw between these two goals.

In a similar vein there is a difference between telling a consumer what he is buying and what he may buy. The writer recommends that no limitations (other than to prevent deceit and fraud) be placed on the type of insurance which may be sold. Groups such as Consumer's Union should certainly have the right to recommend the type of insurance which they think is the "best," but their recommendations should not be enacted into law.[1]

More regulatory as well as industry attention needs to be directed to the area of marketing. Faced with rising costs in all areas, companies and agents are less interested in the small, individual policy, and more interested in "big ticket" policies and group sales. Company President O'Keefe of Amarillo sees "mass merchandising," with premiums paid by payroll deduction, as the only way a company can profitably handle small policies.[2] The expenses of handling such policies will certainly be less than individual solicitations and collections. A similar approach is suggested by Alfred Golden, writing in Insurance Magazine, who called mass marketing "the wave of the future."[3]

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[1] The Life Insurance Industry, Hearings, loc. cit., p. 2255.

[2] Interview, Amarillo, May 14, 1974.

[3] Alfred L. Golden, "Mass Marketing of Insurance," Insurance Magazine, February 1974, p. 16.

Oklahoma Commissioner Hunt sees a danger in such a procedure. "The big companies," he said, "could lower the rates and drive the small companies out of the state, and then raise rates at a later date."[1]

Perhaps increased educational efforts will enable a larger percentage of sales to be made "over the counter" without so much expense in direct selling. A possible trend to this type of selling may be seen in the recent (1970) acquisition of the Great American Reserve Insurance Company of Texas by the J. C. Penney Co. The second largest general merchandising organization in the nation thus joined the largest (Sears, Roebuck & Co.) in sponsorship of a life insurance company.[2] If such a trend continues, increased competition could result, and thus intensify the search for more efficient marketing.

The entire question of mail-order and similar types of sales needs examination. If such methods can lower distribution costs without sacrifice of safety and policyholder service, they merit consideration. The fact that some fraudulent schemes have been promoted through the mail in the past should not condemn all such proposals. Some channel must be provided for the purchase of small policies by individuals,

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[1]Southwestern Insurance Regional, July 31, 1973, p. 2.

[2]Best's Insurance Reports, Life/Health, 1973. Sears has sponsored Allstate Insurance Company for automobile insurance since 1931, and Allstate Life Insurance since 1957.

or the industry may be forced to make such provisions on terms which it does not find attractive.

The industry must continue the search for less costly marketing techniques, and regulatory officials must be responsive. State regulations designed for the traditional methods of selling may hinder the development of innovations.[1]

The writer believes the State Board basically has most of the authority and regulatory tools it needs to assure sound operation of a company insofar as regulation affects it; or to be able to take quick regulatory action if needed. Diligent use of the recommended early-warning tests will detect most trouble spots before they reach a crisis stage. Continued up-grading of the force of examiners and examining actuaries will facilitate the entire process of regulation.

Legislative action is needed to provide a capital requirement that is scaled to the operations of the company. This is widely (though not universally) regarded as a desirable change. Furthermore, the writer recommends that companies now operating under the "grandfather" clause be required to increase their capital and surplus to conform to current requirements within five to ten years.

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[1]For example, in 1972 the Florida Insurance Commissioner brought a complaint against National Home Life Insurance Co. of St Louis because of advertisements featuring Art Linkletter, who did not have a license to sell insurance in Florida. The Company agreed to a $20,000 penalty. ("Florida Calls Art Linkletter Unlicensed Insurance Agent," Consumer Reports, January 1973, p. 51.)

Legislative action would also be needed to provide a series of investment regulations based not on form, but on content of the investment. The writer favors such action, though recognizing that formulating equitable provisions would not be a simple matter.

Even if all these changes were implemented, the industry would not be without problems. Life insurance is both a product and a service, and it is difficult to understand. Consumer ignorance plays a part in the way the market functions, and both the industry and regulatory officials must work to alleviate that ignorance. The industry does not operate capriciously, however, and careful study reveals the traits which are distinctive. The fact that the industry's market operations do not accord with some of the more commonly accepted economic principles does not mean that they are without logical explanation.

With the implementation of the above provisions, a good regulatory system would become even more responsive to the needs of the industry and the public. A final word is necessary concerning entrance to the industry, however.

The writer feels the State Board must be diligent in assuring that applicants for a charter have ". . . sufficient insurance experience, ability, good standing and good record to render success of the proposed insurance company probable."[1]

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[1] Code, Art. 2.01.

The memory of past evils is difficult to eradicate, but it can be overcome. Insofar as possible, the organization of companies designed primarily to benefit the stock promoters must be prevented.

The above provision is a powerful weapon. Its use is subject to abuse in the hands of regulatory officials, for no law can be written to cover every eventuality. The ultimate assurance of wise [illegible]apon can come only through informed and a[illegible]pation in the political process.

APPENDIX A

The memory of past evils is difficult to eradicate, but it can be overcome. Insofar as possible, the organization of companies designed primarily to benefit the stock promoters must be prevented.

The above provision is a powerful weapon. Its use is subject to abuse in the hands of regulatory officials, for no law can be written to cover every eventuality. The ultimate assurance of wise use of the weapon can come only through informed and active citizen participation in the political process.

APPENDIX A

APPENDIX A

WEST TEXAS STATE UNIVERSITY
CANYON. TEXAS 79015

DEPARTMENT OF ECONOMICS

February 8, 1974

Dear Rotarian:

In connection with my study of the Texas Life Insurance industry for my Ph. D. dissertation, I am seeking some information about reasons for purchasing specific life insurance policies. President Tom agreed that it would not be out of line for me to use the membership of the Amarillo Rotary Club for a little sample survey.

There are a number of factors which determine how we spend our money, and the purchase of life insurance seems to be influenced by more "non-market" factors than many other expenditures. An analysis of such factors might be of help in considering the types of regulation which would be beneficial both to the industry and to the public at large. (In December, for example, the State Board of Insurance called a public hearing to consider the ways in which the cost of life insurance is represented to the public by the agents.)

Would you please take a few moments to think back to the last life insurance policy you purchased (or the purchase of which you influenced), and try to recall just why you made that particular decision. Then check the principal reason (or reasons) on the form below and return in the enclosed envelope. (The Head of the Economics Department has authorized this use of postage as part of a proper study in economics, so you won't even be out the price of a stamp!)

I will surely appreciate your response. Although this is a minor part of my study, I feel it is an important one.

Sincerely,

Allen Early
Assistant Professor

The last life insurance policy which I purchased (or was instrumental in purchasing) was primarily determined by:

______ the cost

______ the provisions of that particular policy

______ the agent

______ the company

______ other reasons (please specify)

APPENDIX B

APPENDIX B

No. 37476

OFFICIAL ORDER

of the

COMMISSIONER OF INSURANCE

of the

STATE OF TEXAS
AUSTIN, TEXAS

Date July 7, 1972

Subject Considered:

TEXAS NATIONAL LIFE INSURANCE COMPANY
Dallas, Texas

SUPERVISION ORDER

General remarks and official action taken:

On this day, came on for consideration by the Commissioner of Insurance, the application and consent of TEXAS NATIONAL LIFE INSURANCE COMPANY, Dallas, Texas, and after conferring with management of the company pertaining to the affairs of said company, the Commissioner of Insurance finds that the interest of the public can best be served by placing said company under a state of supervision as provided by the provisions of Article 21.28-A of the Texas Insurance Code.

THEREFORE, under the provisions of Article 21.28-A of the Texas Insurance Code, the Commissioner of Insurance does place TEXAS NATIONAL LIFE INSURANCE COMPANY under supervision. Said company is not to do any of the following acts without the prior approval of the Commissioner of Insurance:

A. Dispose of, convey, transfer or encumber any of its assets (except bank accounts as provided herein) or its business in force.

B. Transfer or withdraw any funds from its bank accounts, except for such sums as are necessary to pay the debts incurred in item F below.

C. Lend any of its funds except for the making of loans required under the terms of its outstanding contracts of insurance.

D. Invest any of its funds except by depositing funds received in the bank accounts of the company established at date of this Order or in certificates of deposit at such banks or in obligations of the United States of America.

E. Transfer any of its property except as provided herein.

F. Incur any debt, obligation or liability except for payment of salaries of its employees, agents' commissions, ordinary expenses of maintaining its home and branch offices (if any) and expenses (including claims) of servicing existing policies, all in accordance with the level and terms that exist on the date of this Order or for lesser amount.

G. Merge or consolidate with another company.

H. Enter into any new reinsurance contract or treaty or terminate existing reinsurance contracts or treaties.

CLAY COTTEN
COMMISSIONER OF INSURANCE

Prepared by:

ROBERT P. CLINES
Attorney

APPENDIX C

APPENDIX C

No. 39053

OFFICIAL ORDER

of the

COMMISSIONER OF INSURANCE

of the

STATE OF TEXAS
AUSTIN, TEXAS

Date January 15, 1973

Subject Considered:

UNIVERSAL INVESTORS LIFE INSURANCE COMPANY
Fort Worth, Texas

ORDER

General remarks and official action taken:

Whereas the Commissioner of Insurance heretofore on October 26, 1970, did place UNIVERSAL INVESTORS LIFE INSURANCE COMPANY, Fort Worth, Texas, under a state of supervision as provided for by Article 21.28-A of the Insurance Code and did appoint M. L. Hartwig supervisor and whereas such company has continued in supervision and M. L. Hartwig is no longer in a position to continue as supervisor and certain tranactions need to be consumated, the Commissioner of Insurance does hereby enter the following order:

1. M. L. Hartwig is hereby discharged as supervisor of UNIVERSAL INVESTORS LIFE INSURANCE COMPANY and in his stead Tom I. McFarling is appointed as conservator.

2. Tom I. McFarling is instructed to consummate a sale of the real property and furniture of UNIVERSAL INVESTORS LIFE INSURANCE COMPANY for $75,000 cash to Thomas I. Fiedler, Trustee, and to deliver appropriate conveyances and enter into appropriate contracts to consummate same.

3. To remove the books, records and property remaining in UNIVERSAL INVESTORS LIFE INSURANCE COMPANY to Austin, Texas.

4. To negotiate and consummate a reinsurance agreement with a solvent Texas licensed life insurer for the remaining life insurance policies of said company (being less than 20 in number) on the best possible terms available.

CLAY COTTEN
COMMISSIONER OF INSURANCE

Prepared by:

Robert P. Clines

APPENDIX D

APPENDIX D

No. 40314

OFFICIAL ORDER

of the

COMMISSIONER OF INSURANCE

of the

STATE OF TEXAS
AUSTIN, TEXAS

Date June 1, 1973

Subject Considered:

FINANCIAL SECURITY LIFE INSURANCE COMPANY
Dallas, Texas

APPOINTMENT OF CONSERVATOR

General remarks and official action taken:

FINANCIAL SECURITY LIFE INSURANCE COMPANY, Dallas, Texas, has requested, petitioned and consented to the appointment of a conservator over the affairs and property of said company, as provided under Article 21.28-A of the Texas Insurance Code.

After considering such request and having found that the request is properly made and that a conservator should be appointed over the affairs and property of said company, the Commissioner of Insurance does hereby, under the provisions of Article 21.28-A of the Texas Insurance Code, place FINANCIAL SECURITY LIFE INSURANCE COMPANY, Dallas, Texas, in conservatorship and does hereby appoint Tom I. McFarling conservator of said company and directs the conservator to take charge of such company and all of the property, books, records, and effects thereof (including, but not limited to, bank accounts, securities, collections of accounts, rentals and other funds due the company, and the control of mail and post office boxes) and conduct the business thereof. The conservator shall make report to the Commissioner of Insurance of the affairs of said company as soon as he ascertains them and shall thereafter make report once each month during the pendency of the conservatorship, and the conservator shall take all necessary measures to preserve protect and recover the assets and property of said company, including claims and causes of action belonging to said company and to defend any suit or suits which have been filed or may hereafter be filed against said company and to file and prosecute any suit or suits necessary or incident to the preservation, protection or recovery of assets and property of said company.

The conservator shall take charge of said company as above set out subject to such further orders and directions as the Commissioner of Insurance deems proper and necessary.

CLAY COTTEN
COMMISSIONER OF INSURANCE

Prepared by:

ROBERT P. CLINES
General Counsel

APPENDIX E

APPENDIX E

29727

June 23, 1969

CONTINENTAL INVESTORS LIFE INSURANCE COMPANY
San Antonio, Texas

CONSERVATORSHIP ORDER

On this day, came on for consideration by the Commissioner of Insurance, the affairs and condition of CONTINENTAL INVESTORS LIFE INSURANCE COMPANY, San Antonio, Texas, and in particular, charges and specifications contained within Commissioner's Order No. 29891, dated April 7, 1969.

A public hearing was held on June 16, 1969, as provided for in the aforesaid Order, at which hearing appeared persons representing the interests of the company. Based upon evidence presented at such hearing, the Commissioner of Insurance finds:

1. That the company has not complied with the requirements of items 2 and 4 of the specifications in that the material required was not provided at a time not later than five days preceeding the date of the hearing.

2. That the company does not have duly installed officers nor a functioning Board of Directors.

3. That the company has not made good deficiencies prohibited by the provisions of Articles 3.02 and 3.60 of the Texas Insurance Code, and that its capital or capital stock is impaired to an extent prohibited by such Articles.

THEREFORE, the Commissioner of Insurance finds that his lawful requirements in the aforesaid Order have not been complied with, and he does, under the provisions of Article 21.28-A of the Texas Insurance Code, appoint Tom I. McFarling conservator of and over the property and affairs of CONTINENTAL INVESTORS LIFE INSURANCE COMPANY, San Antonio, Texas, and does direct him to immediately take charge of such insurance company and all of the property, books and records thereof, and conduct the business thereof. The conservator shall report to the Commissioner of Insurance his findings and recommendations concerning the future conduct of the affairs of the company, including such steps as may be necessary for rehabilitation and his recommendations if rehabilitation is not considered feasible for the orderly reinsurance of the outstanding insurance policies of the company and the liquidation of its affairs.

Prepared by:

ROBERT P. CLINES	CLAY COTTEN
Attorney	COMMISSIONER OF INSURANCE

APPENDIX F

APPENDIX F

From Statement of Joseph M. Belth, U.S., Congress Senate, Committee on the Judiciary, The Life Insurance Industry, Monopoly, 93d Congr., 1st Sess., 1973, pp. 572-3.

Level-premium life insurance, under which the premium remains constant, is a technique adopted by the life insurance industry in an attempt to minimize adverse selection and at the same time make it financially feasible for policyholders to continue their protection even to advanced ages. Such an arrangement requires that the policyholder be overcharged (relative to mortality costs, expenses, and profit) in the early policy years to offset the inadequacy of premiums in the later policy years. The level-premium arrangement and the legislation requiring cash values make life insurance companies major financial institutions and transform what otherwise would be an insurance transaction into a combination or package transaction involving both insurance protection and a savings medium.

Because of the package aspect of cash-value life insurance contracts, it is necessary to distinguish between the "premium" for the contract and the "price" of the protection element of the contract. To compute the price of the protection element, it is necessary to separate the protection element of the policy from the savings element, at least in a theoretical sense. Since the separation involves the making of assumptions, no single price figure can be established as the price; rather, any price figure must be accompanied by a statement concerning the assumptions used in computing the figure.

The nature of a life insurance price figure may be illustrated by an analogy. Assume that an individual is purchasing a package that consists of an item A and an item B. When only the price of the package is given, no single figure can be established as the price of either A or B alone. To calculate the price of A, it is necessary to make as assumption about the price of B, and vice versa. Thus, any figure established as the price of A must be accompanied by a statement about the assumed price of B, and vice versa.

In life insurance, the two parts of the package are protection and savings, and any figure established as the price of protection must be accompanied by a statement about the assumed rate of return on the savings element. Conversely, it is possible to make a statement about the rate of return on the savings element only if an assumption is made about the price of the protection. In short, the price of protection and the rate of return on the savings element are two sides of the same coin, and either can be used to make comparisons among policies.

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